

Submission

No 9

INQUIRY INTO THE PARLIAMENTARY BUDGET OFFICE

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Dear Mr Elliott

INQUIRY INTO THE PARLIAMENTARY BUDGET OFFICE

I am writing in response to your recent invitation for the BCA to make a submission to your Committee's inquiry into the NSW Parliamentary Budget Office.

In January this year, the BCA made a submission to the federal parliament's inquiry into a Parliamentary Budget Office.

The BCA's submission was itself based on a submission to the Commonwealth Budget process and included an associated report prepared for the BCA by the Sapere Research Group on options for enhancing budget integrity in Australia.

Based on analysis in the report, the BCA concluded that long-term fiscal sustainability would be best served through the establishment of an independent Commission of Budget Integrity that fosters public debate, improves understanding of fiscal issues and provides an external source of scrutiny.

I have attached an excerpt from our Commonwealth Budget Submission as well as the Sapere Research Group report for your Committee's information.

I trust that this information may prove useful as the Committee deliberates on the functions, powers and structures of the Parliamentary Budget Office in NSW.

Yours sincerely

Peter Crone
Chief Economist and Director Policy

ATTACHMENT A: EXCERPT FROM BCA BUDGET SUBMISSION

PART FIVE: AN INDEPENDENT COMMISSION OF BUDGET INTEGRITY

Background

In light of the significant budgetary challenges which lie ahead, a good case can be made to effect further institutional reforms that will help drive long-term fiscal sustainability through increased transparency and accountability.

The BCA has for some time been calling on the government to subject the Budget and its spending programmes to greater independent scrutiny. In the past, the BCA has promoted the need for all federal Budget expenditure and revenue policies to be reviewed on a five yearly cycle.

The establishment of a permanent independent fiscal authority would allow for government activities and public sector performance to be assessed independently and objectively. It would allow the community to consider whether programs are meeting their objectives and delivering value for money, and whether ongoing government involvement in particular areas is even appropriate.

The Agreement for a Better Parliament reached between the government and the Independents provided a commitment to establish a Parliamentary Budget Office based in the Parliamentary Library. Its role is expected to include the provision of independent costings, fiscal analysis and research to all members of Parliament, especially non-government members.

The BCA sees the proposal to establish a Parliamentary Budget Office as a positive step but considers that there is a case to go much further and establish a permanent independent Commission of Budget Integrity.

The BCA envisages that such a Commission could make a constructive contribution to long term policy by:

- Enhancing government accountability for the efficiency and effectiveness of federal spending programs;
- Identifying opportunities for improving the effectiveness of government spending; and
- Enhancing the credibility and transparency of Budget estimates.

To assist in considering issues around a new independent fiscal authority, the BCA commissioned a former senior Department of Finance official Mr Stephen Bartos, now with the Sapere Research Group, to prepare an Options Paper. This paper included consideration of the scope of work the Commission could undertake and appropriate governance arrangements dealing with its independence and

operations. A discussion drawing on aspects of the Sapere report is outlined below, while a full copy of the Options Paper prepared is included at Appendix Two.

The Case for an Independent Fiscal Authority

One of the factors contributing to a country's economic performance is the role played by institutions devoted to scrutiny, oversight and advice, both inside and outside government. There is a clear link between the strength and independence of economic institutions and national wellbeing.

Independent institutions such as the Reserve Bank of Australia, Productivity Commission and Australian National Audit Office contribute to Australia's economic performance through enhanced scrutiny, oversight and advice, both inside and outside government. These institutions contribute to good policy governance at a national level and help contribute to public trust and confidence.

Fiscal policy has no equivalent institution and while the advice of agencies like Treasury and Finance is independent, generally robust and well regarded, the advice provided on fiscal policy by these agencies is for the most part confidential and it is not possible to determine the extent to which the government of the day has or has not followed that advice.

The OECD has recently confirmed the usefulness of independent fiscal bodies for economic performance, albeit cautioning that they are not in themselves sufficient to guarantee success and need to be complemented by political commitment to achieving medium term fiscal goals.

More recently, comments from the Department of Finance and Deregulation's Incoming Government Brief highlight the need to prevent complacency and take significant steps to promote greater transparency and accountability of government finances.

Australia has a strong record of budgetary reform. The shift to accrual budgeting in 1999-2000 allowed for an increased focus on the full costs of government's policies and the long term fiscal sustainability of the Commonwealth. To maintain Australia's strong economic and fiscal position, further steps should be taken to enhance transparency and accountability of government finances. The Global Financial Crisis and sovereign debt concerns in other countries provides a salutary lesson for strong public sector financial management.ⁱ

Department of Finance and Deregulation, Incoming Government Brief, 10 September 2010.

Although Australia has developed a strong reputation for the transparency of its Budget documentation, there is no institutionalised independent external assurance or interpretation of the 'official' view of the Budget and government finances.

The further consolidation of a robust long-term fiscal strategy would in the BCA's view be bolstered through inclusion in the institutional framework of an independent Commission of Budget Integrity.

Possible Functions of the Commission of Budget Integrity

A Commission of Budget Integrity could conceivably undertake work including: macroeconomic forecasting; fiscal sustainability reporting; costing of policy proposals; program evaluations; analysis of tax expenditures; budget and fiscal commentary; and the preparation of issues or discussion papers.

The BCA believes the focus of the Commission of Budget Integrity should be on three areas:

- The preparation of Fiscal Sustainability Reports
- Undertaking program evaluation, with an emphasis on independent assessments of value for money; and
- Assessment of Tax Expenditures

Fiscal Sustainability Reports

Preparation of a report on fiscal sustainability, looking at longer term budget pressures and ways of dealing with them, would be a useful addition to the public debate in Australia.

The Congressional Budget Office in the United States, for example, is responsible among other things for formulating a baseline against which the impact of budget proposals can be assessed. It also prepares a number of different long-term forecasts including a ten year outlook (currently available for 2010 to 2020), a long term budget outlook report for the next 70 years (although it indicates that the analysis focuses mainly on the next 25 years), and estimates of social security costs reaching out to 2082. These generate considerable public attention and debate, and help inform fiscal policy.

The Intergenerational Report prepared by the Treasury is a type of Fiscal Sustainability Report and does fulfil an important long-term forecasting function in an Australian context. However, instead of publishing annual revenue, expenditure and budget balance aggregates into the future, the IGR has tended to confine its analysis to the publication of long term charts. An absence of publication of the underlying data detracts, to some extent, to the usefulness of the analysis.

Moreover, as noted in the Sapere report, the 2010 Intergenerational report was more political in tone than some of the previous reports, and was used as an opportunity to promote some government programs such as the National

Broadband Network and Carbon Pollution Reduction Scheme that at the time were subject of dispute politically.

Options for preparing more comprehensive sustainability reports could include:

- Amending the Charter of Budget Honesty Act 1998 to make the Intergenerational Report a responsibility of the independent Commission of Budget Integrity, and broaden the coverage of that report; or
- Publication by the independent Commission of Budget Integrity of other long term forecasts on a more regular basis that draw on, but do not duplicate, the work of the Intergenerational Report.

Program Evaluation

The Commonwealth Government in the past had a requirement that all programs should be subject to an independent evaluation at least every three years. In 1996 this policy was discontinued, for a number of reasons.

There are nonetheless a range of existing mechanisms around program evaluation including the Australian National Audit Office performance audits, Parliamentary inquiries, Productivity Commission inquiries and other commissioned evaluations. Despite this, considerable gaps exist in assessments including from assessor agencies in making clear public judgements about whether particular programs are achieving the key fiscal priority of 'value for money'. In addition, existing program assessment mechanisms are generally not suited to examining large systemic issues as they affect the Budget – for example population and social disadvantage.

Some areas of government spending also tend to be 'off limits' like the tax system for owner-occupied housing or private health insurance.

In light of these limitations, there is a case for an independent agency to be tasked with responsibility for evaluating government programs with a view to better assessing value for money. If it is to avoid duplication and overlap, the responsibility should be confined to significant areas of spending that would not otherwise be caught up in evaluation processes elsewhere in the Commonwealth. Some possible areas could include:

- Better targeting of social welfare payments, and reduction in welfare dependency
- The costs of overlap between the Commonwealth and the States in health and education, and options for a clearer delineation of responsibilities
- Identification of the reasons for growth in public service staff to current levels (the highest on record, adjusted for changes in coverage) and options to contain that growth.

Carefully targeting the role of the Commission of Budget Integrity to look at significant areas of spending, including those that have previously been deemed 'off

limits' could significantly increase transparency of government spending and enhance the efficiency of government programs.

Tax Expenditures

Tax expenditures are the various concessions offered by government to taxpayers both individual and corporate that reduce the amount of tax collected. They have a similar effect to spending programs – they provide a benefit and they reduce the Budget bottom line. Examples of tax expenditures include research and development tax concession and concessions on the taxation of superannuation and on certain rates of excise.

The annual *Tax Expenditures Statement*, published by Treasury indicates that in 2008-09 tax expenditures of around \$102 billion dollars were provided, equivalent to around 8.5 per cent of GDP.ⁱⁱ

Despite being the equivalent of a third of total government spending in that year, these tax expenditures receive scarce scrutiny compared to the Budget and as the Sapere paper suggests 'they are the unloved orphan of fiscal scrutiny, paid little attention and not well understood and analysed'. Examining these expenditures would be a valuable first priority for the Commission of Budget Integrity.

Other roles

In terms of a role for the Commission of Budget Integrity in preparing economic forecasts, there would seem to be little value in replication of the official forecasts as this would simply double the already significant costs involved.

Similarly given the wide range of existing commentary on the Budget, it seems at first glance that providing the Commission of Budget Integrity with a role to comment on the Budget would be of limited benefit. However, the Australian Strategic Policy Institute's annual review of the defence Budget navigates the complexity of the Budget data and synthesises the context and implications, providing an excellent example of the transparency and value of independent analysis.

Providing more meaningful and strategic long-term analysis of the Budget to Parliamentarians and others in the Australian community could play an important role in lifting the level of public debate by increasing the transparency and understanding of Australia's fiscal position.

Undertaking a costings function has the potential to be more problematic for the Commission of Budget Integrity given the political issues around costings and the resource intensive nature of costing exercises. In the event that such a function was given to the independent office, there would have to be a mechanism put in place to ensure that costings did not conflict with published Treasury or Finance costings. It is also inevitable that in preparing such costings, the Commission would have to rely

heavily on input from line and central agencies, which could over time impair the perception of its independence. This has been an ongoing challenge for the UK's Office of Budget Review.

Options and Recommended Model

Based on the analysis of the various functions considered in the Sapere report, the BCA considers that the greatest contribution to long-term fiscal sustainability from a new Commission of Budget Integrity can be made through fostering public debate and improving understanding of fiscal issues as well as providing an external source of scrutiny.

This suggests a primary focus of the Commission of Budget Integrity on fiscal sustainability reporting, targeted program evaluation, and analysis of tax expenditures. There may also be merit in the Commission providing strategic economic briefing and commentary in line with the Australian Strategic Policy Institute model.

To be successful, overseas experience indicates that an independent fiscal office needs to have a clear, explicit and unambiguous mandate, and a structure that matches its mandate.

A key consideration in establishing the Commission of Budget Integrity is the need to avoid duplication and overlap between the new body and the Treasury, Department of Finance, Australian National Audit Office, Productivity Commission and other government bodies. The discussion of possible functions outlined above (and in the Sapere Report) aimed to identify areas where these bodies are not currently active, or ways in which responsibilities might be transferred to a new independent agency.

The Sapere Report has outlined four structural options that would be suitable for establishing a new independent fiscal authority.

1. Provision of a fiscal advisory service from inside the Parliamentary Library
2. A separate independent parliamentary department
3. A separate Commission of Budget Integrity inside government
4. A separate Commission of Budget Integrity funded by but outside of government.

The table below taken from the Options Paper summarises the suitability of a fiscal advisory agency located either within or outside of government to undertake the primary functions listed above. Taking account of the BCA's position on the roles and responsibilities of the Commission of Budget Integrity, it is our preference that the new body be created as a Commonwealth owned company outside of government.

TABLE 2: COMMISSION OF BUDGET INTEGRITY - MATCHING FORM TO FUNCTION		
FUNCTION	LOCATION	
	Within Govt	Outside Govt
Fiscal Sustainability reporting	**	***
Program Evaluations	***	**
Comment on budgetary and economic policy issues	*	***
Publication of Reports and Discussion Papers	**	***
Contributions to media and external debate	*	***

***Moderately Suitable; **Suitable; ***Highly Suitable**

In order to not duplicate functions of existing government bodies such as Treasury and Finance, a new fiscal agency should provide a fresh and independent perspective on budget issues.

A new authority involving a Commonwealth owned company outside of government would place the agency in the most independent and arms length position. It would ensure it could engage in controversial or previously unscrutinised areas and open up an informed public debate on 'value for money' of existing expenditures and the long-term sustainability of finances.

There are existing examples of such an arrangement including Education Services Australia and the National Centre for Social and Economic Modelling (NATSEM). Similarly, the Australian Strategic Policy Institute is another example of an independent agency outside of government but with strong support from within government.

Funding

Based on the functions envisaged and governance model, ongoing annual funding in the order of \$10 million would be necessary for the Commission to fulfil its role effectively. This funding would support around 30 to 40 staff, two senior executives, a Board, access to appropriate research materials and their own website.

The BCA considers that this is a relatively small investment in an institution whose value will be readily quantifiable in the savings to the Budget that originate from its reporting.

In line with the government's fiscal discipline of offsetting all new spending, the BCA proposes that the costs of the Commission be offset by an equivalent reduction in

tax expenditures relating to business income. In 2008-09, Treasury estimated that there were around \$6.5 billion in tax expenditures related to business income suggesting ample scope to identify an appropriate offset.ⁱⁱⁱ

ⁱ Department of Finance and Deregulation, Incoming Government Brief, September 2010

ⁱⁱ Commonwealth of Australia, Tax Expenditures Statement, 2009, p. vii

ⁱⁱⁱ *ibid*, p.5

Enhancing Budget Integrity in Australia

An options paper for the Business Council of Australia

Stephen Bartos

January 2011

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About Sapere Research Group Limited

Sapere Research Group is one of the largest expert consulting firms in Australasia and a leader in provision of independent economic, forensic accounting and public policy services. Sapere provides independent expert testimony, strategic advisory services, data analytics and other advice to Australasia's private sector corporate clients, major law firms, government agencies, and regulatory bodies.

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Executive Summary

There is an active debate at present on the creation of a Parliamentary Budget Office, subject of an inquiry by a Joint Select Committee of the Commonwealth Parliament.

Even were the present makeup of the parliament not a factor, there would be merit in the creation of an independent body to examine and report on the government's budget estimates, economic forecasts and financial management.

Around the world a number of comparable jurisdictions to Australia have such bodies, many created within the last three years. Their mandates and responsibilities differ widely, but the underlying drivers are the same: public demand for greater transparency in government, a need for both the public and parliamentarians to understand better how government budgeting and finance works, and a desire for a more robust debate on fiscal issues.

Dissatisfaction with government economic policy settings following the global financial crisis has been a factor in some countries. However, creation of independent budget scrutiny bodies is also a reflection of a globally widespread decline in trust in government performance over several decades.

This paper presents options for an independent budget office or commission for Australia. Key principles underpinning the options are:

- Achieve value for money through minimising duplication and overlap
- Need for a clear and well defined mandate
- A high level of transparency
- Capacity to make a significant difference to the public debate on fiscal policies.

Four options for such a body are examined:

- a) A Parliamentary Budget Office (PBO) inside the Parliamentary Library
- b) A PBO inside the Parliament, separate from the Library (but still within the Department of Parliamentary Services)
- c) An independent agency of government outside the Parliament
- d) An independent body outside government.

The choice of option depends on the remit it is given. If the main purpose of the body is to provide services and advice to non-government members of parliament, options one or two are desirable. If the objective is to provide not only parliamentarians but also Ministers with an alternative source of advice, and to inform other levels of government and the public, then option three would be suitable. If the primary objective is arms-length, apolitical scrutiny to inform and assist public debate, then option four – an external body such as an independent Commission of Budget Integrity - is preferable.

The functions that could be performed by an independent budget commission are:

- Macroeconomic forecasting; noting however that there would be significant resource costs to adopting a fully blown forecasting function, and a better option might be for the independent body to provide an assurance function in relation to the official forecasts, confirming whether or not they are within acceptable bounds
- Analysis of the sustainability of the fiscal position – including commentary on longer term fiscal pressures and risks to the budget.
- Analysis of tax expenditures – currently a woefully neglected area of government fiscal activity
- Program evaluation, aimed not to duplicate other evaluations conducted within government but with the aim of identifying options to achieve better value for money in significant areas of government spending not otherwise subject to evaluation
- Costing of policy proposals from non-government parliamentarians (a function performed at present outside of the election period, within a limited budget and timeframe, by the Pre-Election Policy Unit in the Parliamentary Library)
- Budget and other economic commentary, including issuing discussion papers and contributions to public debate.

Table of Contents

Executive Summary.....	ii
1 Establishing the need – why independent scrutiny is desirable	1
1.1 Introduction	1
1.2 Purpose of the paper, methodology and structure	2
1.3 The case for change.....	2
2 Practice in other jurisdictions, and lessons to be learned	6
2.1 The UK, USA and Canada – a study in contrasts	6
2.1.1 United Kingdom – the OBR initiative.....	6
2.1.2 USA: CBO, the world’s largest independent budget agency	9
2.1.3 Canada – a difficult birth for a PBO	10
2.2 European Countries other than the UK	13
2.3 An Australian example – NSW	15
3 Functions that could be performed by an PBO or an Independent Commission of Budget Integrity	16
3.1 Economic Forecasting	16
3.1.1 Current practice.....	16
3.1.2 Options for the future	17
3.2 Fiscal sustainability reporting	19
3.2.1 Current practice.....	20
3.2.2 Options for the future	20
3.3 Policy costings.....	21
3.3.1 Current practice.....	21
3.3.2 Options for the future	23
3.4 Program evaluation	24
3.4.1 Current practice.....	24
3.5 Tax expenditures	27
3.5.1 Current practice.....	27
3.5.2 Options for the future	27
3.6 Budget and other economic briefing and commentary.....	28
3.6.1 Current practice.....	28
3.6.2 Options for the future	29

4	Options for structure, location and governance	30
4.1	Structural options.....	30
4.1.1	Fiscal advisory service inside the Parliamentary Library	32
4.1.2	Fiscal advisory body as a separate organisation within the Department of parliamentary Services	33
4.1.3	Fiscal policy agency within government.	34
4.1.4	Fiscal policy agency outside government	35
4.2	Workload, budget and staffing.....	37
4.2.1	Work program	38
4.2.2	Staffing	38
4.2.3	Funding	39
4.3	Comparing the options	40
5	Attachments	41

1 Establishing the need – why independent scrutiny is desirable

1.1 Introduction

There is a lively discussion underway on creation of a Parliamentary Budget Office (PBO) in the Commonwealth Parliament.

In his budget reply speech of 2009 the then Opposition leader put forward a proposal to create such an office and in mid 2010 the Opposition introduced a Bill to that effect in the Senate. An inquiry into the Bill was begun by the Senate Committee on Finance and Public Administration, but was not completed due to the prorogation of the parliament.

Following the 2010 election the negotiations that led to the formation of the government included a commitment to establish a PBO. A Joint Select Committee on the Parliamentary Budget Office was established in November 2010. The Committee is examining possible arrangements for a PBO including its mandate, scope, structure, resourcing and protocols. It is due to report by 31 March 2011.

Other possible approaches have been put forward, including the Commission of Budget Integrity proposed by the Business Council of Australia.

Box 1 – a Commission of Budget Integrity

“...The agreement reached with the independents on parliamentary reform includes a proposal to establish a Parliamentary Budget Office to provide independent costings and research to members of parliament.

This will be a useful first step, but there is a case to go further.

Over the past three years, the BCA has promoted the need for all federal budget expenditure and revenue policies to be reviewed on a five yearly cycle.

The establishment of a beefed-up and permanent Commission of Budget Integrity would allow for government activities and public sector performance to be assessed independently and objectively.

It would allow us to consider whether programs are meeting their objectives and delivering value for money, and whether ongoing government involvement in particular areas is even appropriate.”

*Graham Bradley, President, Business Council of Australia
Address to the National Press Club, 15 September 2010*

1.2 Purpose of the paper, methodology and structure

Even were there not a current discussion in the parliament on creation of a PBO, there is a strong case for introduction of an independent fiscal agency. It is a concept that has been raised in the past in Australian public policy discussion (see Attachment A for a summary of previous proposals) and has numerous supporters among academics and economic commentators. It is increasingly a structure being adopted in other jurisdictions as a desirable mechanism for increasing confidence in budget estimates, transparency in fiscal policy and improvement of economic debate.

The purpose of this paper is to set out options for how an independent fiscal agency could be established in the Australian Government. The options range from a limited function in a small PBO through to a more comprehensive range of functions that could be performed by an independent Commission of Budget Integrity.

Numerous sources of evidence were drawn on in preparation of this paper. We conducted a comprehensive survey of the literature, a review of media reporting in relation to independent fiscal agencies, and examination of the websites of a number of the key independent fiscal agencies internationally. The results of this desktop examination are incorporated in the paper.

Interviews were then conducted with a number of senior officials in government and parliamentary agencies, staff of parliamentarians in Australia, and some independent parliamentary budget offices internationally. The interviews were designed to elicit commentary that went beyond the official record and explored the underlying advantages and disadvantages of different options. All interviews were conducted on the basis of confidentiality, and interviewees are therefore not identified in the paper – however they all provided important insights and their contribution to the work is gratefully acknowledged.

The options paper discusses the underlying case for an independent agency in the following section, and the chapter after covers the experience of other jurisdictions. The paper then outlines possible functions that such a body could perform (Chapter 3), and options for different structural arrangements to match the desired functions (Chapter 4). Attachments cover a summary of previous Australian discussion on the topic, examples from European experience, the literature and a list of references.

1.3 The case for change

There are three important reasons why an independent fiscal agency is highly desirable for Australia. It would help to: improve government's capacity for good fiscal policy and program management; improve public trust in government and public institutions; and enhance Australia's international reputation for good governance.

1) Economic Management

One of the factors contributing to a country's economic performance is the role played by institutions devoted to scrutiny, oversight and advice, both inside and outside government. There is a clear link between the strength and independence of economic institutions and national wellbeing. In Australia, the effective conduct of monetary policy by the Reserve Bank of Australia has been an important contributor to economic prosperity. Other key independent institutions include the review and analysis carried out and injected into public debate by the Productivity Commission, the audit function undertaken by the Australian National Audit Office, and competition monitoring through the Australian Competition and Consumer Commission.

Fiscal policy (tax and spending) has no equivalent institution. This is not to suggest that fiscal policies have been developed without independent advice; the key central economic agencies - the departments of the Treasury and Finance and Deregulation - have a reputation for robust and impartial advice. The Treasury in particular has strongly fostered its reputation for independence. Commonwealth governments of whatever political persuasion in recent decades have encouraged these agencies to provide frank and impartial advice.

Nevertheless, under the Westminster system of government there is always the potential for a future government to depart from recent practice in this regard, to the detriment of the economy. Moreover, the advice provided to Ministers by these agencies is for the most part confidential¹, and it is therefore generally impossible to determine the extent to which a government has or has not followed that advice.

The OECD has recently confirmed the usefulness of independent fiscal bodies for economic performance, albeit cautioning that they are not in themselves sufficient to guarantee success and need to be complemented by political commitment to achieving medium term fiscal goals.

Box 2 – Independent fiscal institutions and economic performance.

Experience and empirical evidence suggest that delegating macroeconomic forecasting to an independent fiscal council can indeed reduce forecasting bias. There is some empirical evidence that independent fiscal institutions can buttress a government's capacity to comply with a numerical rule. Good fiscal institutions are a necessary condition for achieving disciplined fiscal performance. Experience demonstrates, however, that their existence is 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.

Hagemann, OECD, 2010

¹ With the commendable recent exception that both central economic agencies published large portions of their briefings to the incoming government in 2010 – an initiative that greatly enhanced transparency and reflected well on those departments and the government.

2) *Trust*

Alongside improved economic performance, it is also important that citizens perceive government as being able to influence that performance in an effective way. Public confidence in government has been in decline in most of the western world including in Australia. A key reason worldwide is “citizens’ perception that the government is incapable of dealing with the current fiscal and financial challenges” (Blind, 2006).

A Scanlon Foundation survey (Markus, 2010) found that in 2010 only 31 per cent of Australians trusted their government ‘to do the right thing for the Australian people’. The survey methodology does not provide a precise reason for this low level of trust, and notes that it correlates with declining popular support for the then government. In the same survey however the most frequent response to the question ‘What do you think are the most important problems facing Australia today?’ was the category ‘Economy/unemployment/ poverty’. It would be reasonable to infer that perceptions of how well government deals with these economic problems would affect respondents’ levels of trust.

Economic management is consistently nominated in opinion polls as an important issue for voters. In the July 2010 Newspoll² published in *The Australian* ‘the economy’ rated third most important issue affecting voting intentions (behind ‘health and medicare’ and ‘education’); it was the most important when the same poll was taken in February 2009.

A better informed public debate on fiscal matters would enhance business and public confidence in government. Budget and fiscal policy issues are not well understood in the Australian community at large. Media reporting on budget issues tends to be superficial, with a focus on the budget balance (surplus or deficit) or large tax or spending announcements. Commentary is guided strongly by the media management of the Treasurer of the day. Stakeholders consulted for this study commented that even parliamentarians in many cases face difficulty in coming to terms with the details of budget papers or the estimates underpinning vitally important fiscal decisions.

For most of the community budgeting remains a mysterious ‘black box’ process inside government. A feature of a healthy democracy is informed debate on important policy issues; economic policy should not be an exception.

3) *Good governance*

Although Australia has developed a strong reputation for the transparency of its budget documentation, there is no institutionalised independent external assurance or interpretation of the “official” view of the budget and government finances. This stands in contrast to many other comparable countries.

² At www.newspoll.com.au viewed 12 November 2010

In the 1980s and 1990s Australia was one of the leading OECD countries in terms of economic and public sector reform. In 2004 Australia received a United Nations award for Improvement of the Quality of the Public Service Process in the Asia-Pacific region. As noted by the responsible Minister at the time “it reflects substantial public sector reform spanning two decades of management and workplace change and culminating in the Public Service Act 1999”³.

As that statement suggests, international recognition builds slowly over time, and the lags are considerable. Countries’ relative standings therefore tend to change slowly, but nonetheless they do change over time as national systems of governance evolve.

Many other countries have recognised or are recognising the benefits of an independent fiscal agency (see following section). All other things being equal, Australia’s standing as an open and transparent economy and reputation for good governance will decline if we fail to learn from that experience, harming our international competitiveness over the longer term.

Our standing in international ratings is relatively high today. Such indices include the World Economic Forum global competitiveness report (16th in 2010, down a place from 2009), the Transparency International corruption perceptions index (ranked 8th in 2010) and the World Bank survey of ease of doing business (ranked 10th in 2010).

However, this is no reason for complacency or for ignoring the compelling case for reform. An investment in desirable institutional reform now will have long term payoffs and either enhance our standing or at the least help stave off decline.

An independent fiscal body is only one of many possible factors contributing to national transparency and economic performance. Introducing such a body in Australia would be a desirable reform, but of itself would not guarantee better budgeting. Economic performance will continue also to require discipline and commitment on the part of government, supported by effective scrutiny from parliament, the media and community.

³ Media Release, Kevin Andrews MP, at www.apsc.gov.au viewed 12 December 2010

2 Practice in other jurisdictions, and lessons to be learned

Many other advanced economies have much stronger independent scrutiny of government spending than does Australia. Some are long established (the Netherlands, Denmark and USA) while others are more recent. Important lessons for Australia from those experiences are covered in this section of the report.

2.1 The UK, USA and Canada – a study in contrasts

Three large English-speaking countries from which Australia frequently draws lessons in public sector management have independent fiscal offices. They are very different in nature, reflecting the different institutional history of each country.

A key lesson from the sharp differences between these examples is that there is no simple template for an independent fiscal body that can be applied from one jurisdiction to another. The functions and structure of such a body depend heavily on political history, other national institutions, and the economic policy challenges faced by the country in question.

2.1.1 United Kingdom – the OBR initiative

The British government established the Office for Budget Responsibility (OBR) in May 2010. An interim Committee helped with the establishment phase of the OBR. Since October 2010 Robert Choate has been Chairman of the OBR. He was recruited from an independent think tank, the UK Institute for Fiscal Studies, and was formerly a senior economic journalist. Choate, together with a well respected professor of economics and a former high ranking Treasury official comprise the Budget Responsibility Committee, the formal OBR body that authorises its independent opinions on forecasts for the budget and its judgements on the states of public finances.

The role of the OBR is to make “independent assessments of the public finances and the economy... [and] of the public sector balance sheet”. Details of its mandate and structure are spelt out at the website of the Office.

Its most significant publication to date has been the November 2010 *Economic and Fiscal Outlook*. This is a comprehensive 152 page publication that provides economic forecasts for key indicators such as economic growth (Gross Domestic Product), inflation and employment for the current year and five years into the future.

These forecasts were previously provided in Budget and Pre-budget reports prepared within the Treasury and presented by the Chancellor or the Exchequer. This past UK practice is very much equivalent to the present Australian practice (see section 2.4 below).

A bill to establish the OBR on a permanent footing, the *Budget Responsibility and National Audit Bill [HL] 2010-11* is, at time of writing, in the committee stage in the House of Lords, where the bill originated.

The House of Commons Treasury Committee conducted an inquiry into the OBR in mid 2010, and reported on 16 September 2010. The submissions and evidence provided to the Committee were largely positive about the anticipated role of the OBR, but there were some criticisms including its closeness (both physically and in terms of staffing) to Treasury, small budget, and lack of transparency in its forecasting methodology.

Box 2 – Extracts, House of Commons Treasury Committee report on the OBR

The Chancellor of the Exchequer has taken a bold step in giving responsibility for drawing up the Government's budget forecast to an independent body, the Office for Budget Responsibility...

For the OBR to succeed, it will have to be, and be seen to be, independent. There are obvious challenges in ensuring the independence of a body which will produce the forecasts which the Government uses in its budget, and which will have to draw on government resources in its forecasting role....

If it is to be successful, the OBR will provide clear, impartial forecasts and commentary which improve public debate. It will avoid being drawn into political controversy, even though the material it provides will inevitably be used by others in political debate.

The OBR has a budget, at present, of £1.75m per annum (around \$A2.8m). Although its key publications are authorised by the Budget Responsibility Committee, none of whom are currently Treasury staff (and only one was formerly), most of its employees have a Treasury background.

Key features of relevance to Australia

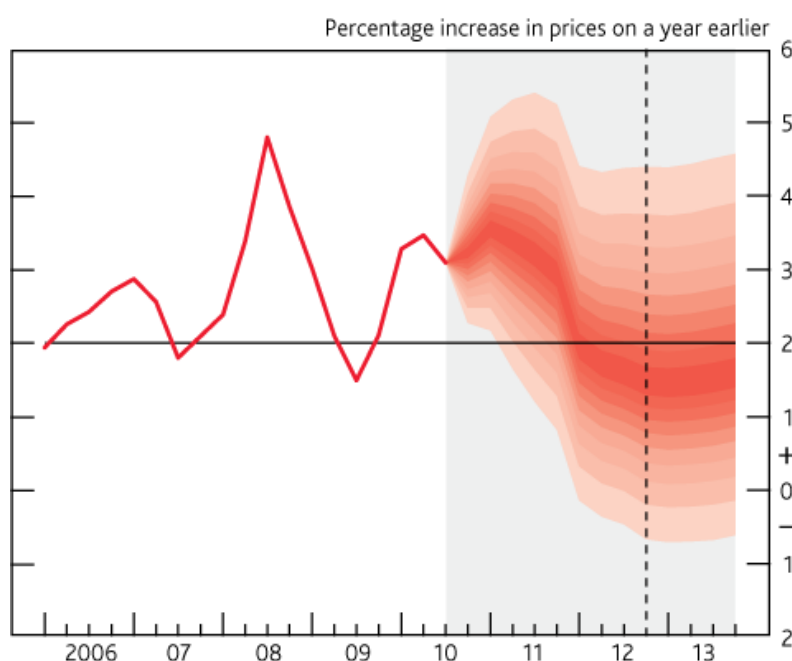
The OBR has a very high degree of independence. Its main purpose however is economic forecasting, and it therefore needs to maintain strong relationships with, and for much of its information is wholly reliant on, the Treasury and the Bank of England. Although it has drawn many of its staff from HM Treasury, it is a separate body and sees its separation as an important component of independence, to the extent of seeking to move physically away from the same building. The tension between the need to have very close links with Treasury in order to be able to undertake its work, while still maintaining independence, is one which any similar body will face in Australia.

Some of its presentation of information is more nuanced than forecasts published in the Australian budget papers – in particular, it presents “fan diagrams” that show the range of uncertainty in future forecasts (for example, its forecast for GDP growth of 2.7 per cent in 2015 is within a band that suggests this could be within a range from 0 to 5 per

cent, at different degrees of probability). The ‘fan diagram’ approach has been used by the Bank of England since 1997 in producing its estimates of inflation, and has become a favoured technique for conveying the uncertainty around such forecasts (King, 2010).

A notable feature of the fan diagram approach is that it graphically illustrates the rapidly increasing uncertainty of estimates the further out they extend in time. A recent Bank of England fan chart shown in Figure 1 below illustrates the approach.

Figure 1 - Bank of England November 2010 Inflation Report – Fan Chart⁴



The high degree of independence given to the OBR reflects a confluence of politics and economics. The political dimension was election of a new coalition government; both coalition partners prior to the election had commented on the desirability more transparency and independence in budgeting. The economic dimension was the severe effect on the UK economy of the global financial crisis, and the new government’s program of fiscal stringency instituted to restore the national public sector balance sheet.

⁴ An explanation of the chart from the Bank’s May 2002 Inflation Report includes: “The fan chart depicts the probability of various outcomes for ...inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution is covered. The outcomes bands widen as the time horizon is extended...”.

In these circumstances, a high level of independence from government was an important factor in ensuring the OBR would be perceived as free from government influence. It has been presented as a key reform to restore fiscal integrity and good economic management to an economy in difficult straits.

2.1.2 USA: CBO, the world's largest independent budget agency

The Congressional Budget Office (CBO) provides the United States' Congress with analysis to aid in economic and budgetary decisions on programs covered by the federal budget. CBO is responsible among other things for formulating a baseline against which the impact of budget proposals can be assessed, and reviewing the President's annual budget submission. It issues an annual Economic and Budget Outlook plus a mid-year update to the House and Senate Committees. It also provides a Long-Term Budget Outlook that presents illustrative scenarios for federal spending and revenues to 2050 and describes the implications of those scenarios for the economy.

The Speaker of the House of Representatives and the President of the Senate jointly appoint the CBO Director. The Director's term of office is four years, with no limit on the number of terms a Director may serve. Either House of Congress may remove the Director by resolution.

The *Congressional Budget and Impoundment Control Act* of 1974 (the Budget Act) is the basic legislative foundation for budget procedures (although amended by other Acts since its basic elements remain in place). It was passed in response to a long history of budget conflicts between presidents and the legislative branch in the US system of government. The Budget Act assumed that lawmakers would behave more responsibly if they faced up to budget totals and voted explicitly on budget aggregates. It also created the CBO to serve as the "scorekeeper" for Congress and assist it to understand the totality of the budget figures on which it deliberated.

The mandate and authority of the Office has grown considerably since. It now publishes not only budget forecasts and analyses but also thorough, well researched papers on many of the major economic and budgetary issues facing the USA. Its analytical studies are prepared "at the request of a Congressional Committee or Subcommittee; the Congressional leadership; or, as time permits, individual Members" (information at www.cbo.gov/aboutcbo). They encompass difficult and highly contested policy areas such as greenhouse gas abatement, health reform and immigration. Most of its work is published, and its reports are widely read and highly influential in debate not only in the Congress but elsewhere in government, the media and the community.

The CBO has a budget of \$US45.2m in 2010 and a staff of some 250 people. A majority of staff have economics or public policy qualifications, frequently at postgraduate level.

Key features of relevance to Australia

Despite the differences in scale between the US and Australian budgets there are useful lessons for Australia in the approach adopted by the CBO. In particular, its level of independence has been built up over time, and the type of influence it has on policy debates has developed progressively, with the current high level of performance built on past achievement. It did not start off by entering the deeply controversial end of the policy pool.

The other key feature to note is the excellent online (and hitherto on paper) transparency of the CBO – its published reports are widely used by media, other policy institutions and decision makers not only within the Congress but also within the executive.

The institutional structure of the USA is however very different to Australia. Despite some similarities, the role of the CBO as a large, powerful, well established arm of Congress is primarily due to that country's much stronger separation of powers between the executive and the legislature.

The system of budgeting is complex and intricate; the phrase “the President proposes, the Congress disposes” reflects the different roles of the executive and legislature, where the legislature is much more in control of the budget process, especially since the passage of the Budget Act and creation of the CBO in 1974.

The reality of the US system is that the final shape of the budget is largely reflective of the Congressional process, and the extent to which the executive influences the budget comes down to the President and key staff members' powers of persuasion. For this reason, a large and influential CBO is a necessary part of the system. However, the strength of the CBO is also reflective of a decline in the influence of the Office of Management and Budget, the budgeting agency that reports to the President. In the 1980s in particular its forecasting and budgeting credibility waned as it resorted to dubious figures (including what former OMB director David Stockman described as a “magic asterisk” that was employed to make future deficits disappear from the estimates). One interviewee for this project reflected that this was a scenario Australia should be careful to avoid.

2.1.3 Canada – a difficult birth for a PBO

The Conservative government of Stephen Harper, elected in 2006, came to office with a strong mandate to increase transparency and accountability.

One of its early initiatives was passage of the Federal Accountability Act, containing widespread changes to accounting and disclosure, appointment processes, restrictions on lobbying, and other institutional mechanisms to improve accountability. Among these was a Parliamentary Budget office within the Parliamentary Library.

The office was established through amendments to the *Parliament of Canada Act*. Its role is “to provide independent analysis to Parliament on the state of the nation's

finances, the government's estimates and trends in the Canadian economy". The first Parliamentary Budget Officer, Kevin Page, was appointed in March 2008. The Office has a budget of \$C2.8m.

Box 3 – the establishment of the Canadian PBO

Improving the transparency and credibility of the Government's fiscal forecasting and budget planning process is a fundamental step in making it more accountable to Parliament and to Canadians. Parliamentary committees should have access to independent, objective analysis and advice on economic and fiscal issues, supported by the timely provision of accurate information from departments and agencies.

The Federal Accountability Act will introduce the following changes:

- The Act will expand the mandate and resources of the non-partisan Library of Parliament by establishing within it the position of Parliamentary Budget Officer.
- It will give this Officer the mandate to:
 - provide objective analysis to the Senate and House of Commons concerning the state of the nation's finances and trends in the national economy;
 - undertake economic and fiscal research for the Standing Committee on Finance, the Standing Committee on Public Accounts, or the Senate Standing Committee on National Finance, on the request of these committees; and
 - estimate the financial cost of proposals currently or prospectively under consideration in either House when requested to do so by a Member, a committee of the Senate or the House of Commons, or a committee of both Houses.
- It will require that departments and agencies provide the Officer with existing data necessary to fulfill his or her mandate.

Source: *Federal Accountability Action Plan, April 2006*. Treasury Board of Canada Secretariat at www.tbs-sct.gc.ca/faa-lfi/docs/ap-pa/ap-pa06-eng.asp viewed 10 December 2010

The PBO in Canada has had an uneasy relationship with the Parliamentary Library. Some interviewees for this project who have observed the situation from a distance suggested there was some tension between the cultures of between the PBO's staff of professional ex-Finance department analysts and Library staff.

In addition, the PBO has clashed with the government over forecasts and fiscal policy, which has led to strained relations over budget and authority for the Office. To understand this conflict it should be noted that in a Westminster system such as Canada the government by definition has a majority in the lower house of the legislature, and

government MPs in the Canadian system do not have as strong a tradition as in Australia of asserting parliamentary autonomy over the government in relation to the parliament's resourcing and operations.

Box 4 – Battles over the Canadian PBO

Last year, a dramatic public battle took place over how independent the Parliamentary Budget Office actually is. When Mr. Page was appointed in March 2008 as a result of the position being created under the Federal Accountability Act, he interpreted the position as an independent officer of Parliament.

Others, including the Speakers for both the House and Senate, maintained their interpretation that the position was an office within the Library of Parliament, which meant that Mr. Page would report to the Parliamentary Librarian rather than Parliament itself.

The Joint Library of Parliament committee later stepped in to also define his role as one within the Library, and in order for the office to receive the \$2.8-million budget increase last year that it was expecting when the office was first created, Mr. Page would have to follow a certain number of rules, such as working within pre-existing Library of Parliament structures and keeping reports confidential unless released by the Parliamentarian who requested it.

The Hill Times Online September 20 2010

Eventually these difficulties were resolved and the PBO given its budget and operational freedom, but not before it had lost two of its key senior staff.

Key features of relevance to Australia

Fundamental to the difficulties experienced by the PBO in Canada is a mismatch between its very broad mandate and relatively small budget. The dispute over its budget in 2009 highlighted the vulnerability of the office. The PBO is dependent on government for funding, while providing independent advice that may at times conflict with the narrative that same government wants to present to the public on fiscal matters.

The location of the PBO within the Parliamentary Library also proved problematic not only because of initial cultural mismatches referred to above, but also because of divergences in the two bodies' timeframe and focus. In Canada the Parliamentary Library, like Australia's, needs to respond to day to day requests for research and advice from parliamentarians. It operates according to the immediate priorities of parliamentarians in a contested political climate, and also (again, as in Australia) is often asked to provide advice to parliamentarians confidentially.

By contrast, the PBO has a focus on long term fiscal sustainability and a strong commitment to open publication and transparency. While not necessarily in conflict, there is a possible friction between these different approaches, especially when it comes to difficult fiscal policy questions that divide major political parties.

2.2 European Countries other than the UK

Many European countries have an organisation – often in the form of a fiscal council - to provide independent review of budgets or economic policies. Although some have existed for many years (for example, the CPB in the Netherlands), in the last three years new Fiscal Councils have been created in several other countries including Sweden, Slovenia and Hungary.

These moves have been given impetus by the 21 October 2010 report of a taskforce chaired by EU President Herman Van Rompuy *Strengthening Economic governance in the EU*. Among the findings of the report was that:

“Stronger institutions both at national and EU level will contribute to improve economic governance. At the national level, the Task Force recommends the use or setting up of public institutions or bodies to provide independent analysis, assessments and forecasts on domestic fiscal policy matters as a way to reinforcing fiscal governance and ensuring long-term sustainability”.

The table below provides an indication of the kinds of bodies now in existence. A summary of the various arrangements is provided at Attachment B.

Table 1 – European Fiscal Councils or similar bodies

Country	Body	When Established	Functions
Netherlands	Bureau for Economic Policy Analysis	1945	Economic forecasts, evaluation of election policies, specific issues papers
Denmark	Economic Council, Environmental Economic Council	1962 2007	2-3 year economic forecasts, analysis of specific topics
Belgium	High Council of Finance; Federal Planning Bureau	1989 1994	Coordination of regional and national fiscal policy medium term objectives for regional and national budget deficits, analysis and forecasting

Sweden	Fiscal Policy Council	2007	Monitoring sustainability of fiscal policy, employment and growth forecasts, evaluation of cyclical fiscal policy, explanation of government policy
Hungary	Fiscal Council of the Republic of Hungary	2009	Macroeconomic forecasts, comment and advice on fiscal planning
Slovenia	Fiscal Council	2009	Assessment of: sustainability of fiscal policy, efficiency in use of public funds, trends in revenue and expenditure, transparency in finances, quality of economic forecasts

Key features of relevance to Australia

Many of the examples above are observed in countries, which have a long history of coalition governments and budget processes based on consensus building among different groupings in their parliaments. This makes the role of an external body capable of providing scrutiny and advice on fiscal issues more central than it would be likely to be in Australia.

The most interesting recent example from an Australian perspective is in Sweden, where the mandate of the Fiscal Policy Council is very wide, including both forecasting and evaluation of government programs. It is not clear how the independence of the office reconciles with its role of explaining fiscal aspects of government policies to the public; it will be tested in the event that the Council concludes that a policy advanced by the government of the day is fiscally irresponsible (noting this is less of a possibility in a consensual system of government than in a Westminster – there is a lower likelihood of the type of conflict that has characterised the Canadian experience).

2.3 An Australian example – NSW

New South Wales is in the process of establishing an independent Parliamentary Budget Office. From public statements to date by the NSW Treasurer⁵ its main focus will be costing of election policies, with a staff of economists, accountants and analysts. It will also have an ongoing role outside election periods in “economic policy advice and research, and the costing of Bills introduced to Parliament”.

Figures provided in the NSW Bill to establish a Parliamentary Budget Office indicate that: “the office will require approximately 12 to 16 qualified and experienced economists, accountants and financial analysts covering the key spending areas and requisite support staff. The office will receive up to \$4 million-recurrent and capital funding combined-in 2010-11 in order to establish the Parliamentary Budget Office, and up to \$3 million recurrent”. The media statements from the NSW Treasurer confirm it will have 16 staff.

Given that NSW has budget expenses of \$56.9b, compared with the Commonwealth’s expenses of \$354.6b, a pro-rata calculation (approximately 6:1) would suggest a setup cost for a Commonwealth office with equivalent functions of around \$24m; ongoing funding of around \$18m; and staffing of around 90 people. There could be economies of scale in a larger office that would reduce these figures; in any event, there are such differences in the nature of both revenue and expenses between a State and the Commonwealth government that mean direct pro-rata comparisons are at best indicative of scale. The resourcing for any Commonwealth independent fiscal body should be determined in reference to the functions it is designed to perform – analysed in the following section.

⁵ Media Releases, Eric Roozendaal MP, NSW Treasurer, *What Have you Got to Hide Barry?* 20 October 2010 and *There’s nothing left to hide Barry* 26 October 2010

3 Functions that could be performed by an PBO or an Independent Commission of Budget Integrity

This section outlines the advantages and disadvantages of an independent fiscal agency undertaking different types of work: macroeconomic forecasting; sustainability reporting; costing of policy proposals; program evaluations; analysis of tax expenditures; budget and fiscal commentary; preparation of issues or discussion papers; and possible other functions.

3.1 Economic Forecasting

3.1.1 Current practice

Official economic forecasts in the budget papers and other updates are presented to the Parliament by the Treasurer and Minister for Finance and Deregulation in the annual Budget (Budget Paper One) and in the Mid-Year Economic and Fiscal Outlook. One set of Australian forecasts and estimates of revenue and expenses, the Pre-Election Fiscal Outlook, is prepared independently by Treasury and Finance under the *Charter of Budget Honesty Act 1998*. At other times forecasts are the government's and presented by Ministers, albeit reliant heavily on Treasury advice.

Within the bureaucracy preparation of the budget's economic forecasts is primarily the responsibility of the Treasury. The forecasts are considered by a standing inter-agency committee, the Joint Economic Forecasting Group (JEFG), comprised of the Commonwealth Treasury, Department of the Prime Minister and Cabinet, Department of Finance and Deregulation, and Reserve Bank of Australia. JEFG is mainly a consultative mechanism to assist Treasury in the construction of the economic forecasts. The Reserve Bank provides input through JEFG, but this is not taken as an endorsement of the JEFG forecasts; although the Bank contributes information through the JEFG process it can and sometimes does publish its own forecasts that differ from those in the Budget.

For a detailed account of forecasting in Australia see Hawkins (2005).

A number of different forecasts appear in the Budget and MYEFO, including not only the often quoted growth forecast but also inflation, employment, household consumption, private and public demand, exports, imports and others (see Table 1 of Budget Statement 2 at page 2-7 in 2010-11 Budget Paper One).

Forecasts are presented in the Australian Budget as single figures, rather than as the ranges in a fan diagram that is now the OBR practice in the United Kingdom. The budget papers do however indicate that the forecasts are subject to uncertainty, and readers can calculate (and the budget papers describe) the sensitivity of the budget

estimates to changed assumptions about a number of the key forecasts. Nevertheless the figures are often presented in media commentary as firm predictions rather than forecasts subject to uncertainty.

3.1.2 Options for the future

In some of the countries previously examined in chapter 2, economic forecasts are prepared by the fiscal council or similar body. Not all countries use government agencies to prepare budget forecasts – in Canada the budget uses an average of private sector forecasts (although the Finance Ministry also constructs forecasts in-house, these are not published and are not the basis of the budget). In the USA there is a multitude of forecasts produced by different analysts and independent think tanks, together with official forecasts prepared by the administration. The forecasts provided by the CBO however are generally used in public debate as the most authoritative and reliable.

Unlike some of the countries surveyed, Australia already has a history of well developed and reliable government forecasts that are generally accepted as independent and impartial (although there has been some criticism of Treasury forecasts in recent years, see e.g. Carling (2009)). To what extent would it be desirable for a separate office to develop its own forecasts separate from the official JFEG forecasts? Would such an office have any credibility in preparing its own forecasts?

The House of Commons Treasury Committee inquiry (see section 2.1.1 above) has struggled with the question of the forecasting role for the OBR. Under the heading “the dilemma” the committee report notes that:

The majority of fiscal councils comment externally on government forecasts or produce their own forecasts. They are not, therefore, involved in the policy-making process leading up to the publication of a Budget. The information they use is for the most part in the public domain. The staff of the council are employed entirely by the council itself.

The OBR is in a more difficult position. In the run up to the Budget it is producing the official forecasts for government, in the light of policy options that have not yet been settled —let alone made public. The requirements for confidentiality and access to internal government information and knowledge are therefore much higher. The question is, how to ensure these requirements are met without compromising the OBR's independence?...[quoting Sir Alan Budd] the involvement of officials working in the Treasury, HMRC and DWP is absolutely inevitable. They command the detailed knowledge of the policies and programmes; they work on the policy changes, if any; and they are the experts on the effects of those policy changes...how does the OBR perform this task which has been allotted to it, which involves using departmental officials, whilst ensuring its independence and satisfying the world that it is independent?...around 100 staff in the Treasury, HMRC and DWP who are involved in drawing up the Budget forecasts.

A similar situation prevails in Australia. Interviewees for this project stressed the resource intensive nature of the forecasting conducted by Treasury and other agencies. The issue with forecasting is not the acquisition of a forecasting model (a version of a computable general equilibrium model can even be downloaded free of charge from the Centre of Policy Studies at Monash University). The resources required are a consequence of a) maintenance of the model (populating it with up to date economic data, improving or amending the algorithms used, ensuring latest modelling research is incorporated) and b) using it skilfully to prepare reliable forecasts (the forecasts produced by a model are only as good as the parameters that are input). One interviewee suggested that “it would take 30-40 people to run the ruler over the official forecasts”. Preparation of the full range of forecasts through a separate agency might require a budget of anywhere between \$10-12m ongoing and up to \$20m in its establishment phase (depending on access to IT resources and sources of information).

In addition to staff in Treasury involved in preparing the economic forecasts, staff in other departments including the Departments of Finance and Deregulation and Prime Minister and Cabinet, and in some cases line departments, contribute to the forecasts. For example, the Finance department plays an important role in estimation of public sector final demand; the department of Families, Housing, Community Services and Indigenous Affairs may have input in relation to unemployment numbers; and other agencies could be called on to assist with aspects of economic forecasting from time to time. To replicate this function would require not only a large staff and but also the authority to acquire information from other government agencies as inputs to the task.

There would seem no real value to taxpayers in replication of the official forecasts in a separate body: this would simply double the already significant costs involved. It is moreover likely that there would be small differences in forecasts produced by different bodies given that the forecasts are always subject to some uncertainty. This in itself carries risks – where Treasury and the fiscal agency produced different forecasts, an unedifying and complicated debate about forecasting methodologies could erupt, and potentially be used or misused in political debate. If taken to extremes this could even possibly undermine market confidence in Australian fiscal integrity.

One option advanced in interviews conducted for this report was that the independent fiscal agency could aid in public understanding of the budget by preparing forecasts for years just outside the three forward estimates years – that is, four, five or six years after the budget year. There is potential value in showing the costs of government policies in this way. In particular, some large expenditure programs with long implementation lead times can appear in the forward estimates to be relatively inexpensive, although in a full year of operation they may be very costly options. Similar concerns could potentially apply to revenue measures.

The options in relation to budget forecasts could be:

- a) Make the official forecasts the responsibility of the new independent fiscal agency and transfer the function to it from the Treasury. This option would be strongly resisted by Treasury, which sees the preparation of the official forecasts

as one of its core tasks. It does have precedents internationally, and administratively would be easy to implement⁶.

- b) Give the fiscal agency responsibility for providing independent comment on the official forecasts. In this option it could examine the forecasts, provide an opinion on factors such as their internal consistency, whether they are based on reliable external evidence, and whether they fall within a reasonable range. This is not a function currently undertaken in Australia and one which would be likely to be welcomed by government agencies. Although Australian governments to date have not manipulated the official forecasts for political purposes, an independent assurance mechanism would be a safeguard against any such practice in the future.
- c) Give the independent agency the resources to prepare in house, or contract out, projections for later years outside the forward estimates period for selected key official forecasts (there are a number of independent bodies with the capacity to prepare forecasts, either in universities or the private sector).

3.2 Fiscal sustainability reporting

Another possible function for an independent fiscal agency would be to prepare long term forecasts of the kind prepared by fiscal agencies in other countries. Notably, the CBO in the United States prepares a number of different long term forecasts including a ten year outlook (currently available for 2010 to 2020), a long term budget outlook report for the next 70 years⁷ (although it indicates that the analysis focuses mainly on the next 25 years), and estimates of social security costs reaching out to 2082⁸. These generate considerable public attention and debate, and help inform fiscal policy.

More recently, US President Barak Obama established a National Commission on Fiscal Responsibility and Reform. Its December 2010 Report *The Moment of Truth* identified options to bring unsustainable growth in the United States' Federal debt under control. It provided estimates of deficits and debt out to 2040, and even longer term projections – the next 75 years – for social security. The National Commission on Fiscal

⁶ If the agency were within government, it could be done simply through a change to the Administrative Arrangements Order and transfer of the relevant staff.

⁷ *The Long-Term Budget Outlook* CBO, June 2010

⁸ *Updated Long Term Projections for Social Security*, issued in 2008, provides ranges and scenarios over a 90 year timeframe

Responsibility and Reform drew heavily on CBO data, the best long term fiscal analyses available.

The Danish Environmental Economic Council has a particular focus on the interactions between environmental and economic sustainability, including in areas such as energy and agriculture.

3.2.1 Current practice

The *Intergenerational Report* prepared by the Treasury in Australia fulfils some of this long term forecasting function. Section 21 of the *Charter of Budget Honesty Act 1998* provides that:

“An intergenerational report is to assess the long term sustainability of current Government policies over the 40 years following the release of the report, including by taking account of the financial implications of demographic change.”

Under the Act the report is to be prepared every five years, although the last report in 2010 was only three years after the previous report. The report covered a wide range of issues; although it was dominated (as a consequence of its mandate under the Act) by demographic issues, and especially the aging of the population, it also covered issues such as climate change, skills and social inclusion.

Unlike the CBO reports, or the report from the National Commission on Fiscal Responsibility and Reform in the USA, the *Intergenerational Report* does not provide long term forecasts of revenues and expenses. Instead it provides long term projections of key figures such as net debt, underlying cash balance and net worth expressed as percentages of GDP. This is useful information, but its significance is not always apparent to readers because it is a very different format to that used for numbers in the budget papers and other economic documents.

The 2010 report was more political in tone than some of the previous reports, and was used as an opportunity by the government to promote some of its programs such as the National Broadband Network and Carbon Pollution Reduction Scheme that at the time were subject of dispute politically.

3.2.2 Options for the future

Preparation of a report on fiscal sustainability, looking at longer term budget pressures and ways of dealing with them, would be a useful addition to the public debate in Australia. As well as the focus on population aging seen in the *Intergenerational Report* such a publication could examine questions such as: the future prospects for Australian industry, trends in international competitiveness, and their implications for tax revenue; pressures on government spending from growth in entitlement programs other than the aged pension; labour markets and education; options for making provision for unexpected future downturns that might affect the economy. It would also provide a

greater range of analytical tools to enable readers to understand how the longer term forecasts relate to the figures presented in the annual budget papers.

In some countries there is also reporting on the cyclical state of the budget – that is, whether taking into account economic cycles the budget is in a sustainable position. Simplistic debates about whether a budget is in a surplus or deficit are not helpful to public understanding of fiscal issues – neither is necessarily a good or bad budget balance. Whether a surplus or deficit in the budget bottom line is desirable depends on the state of the economy as a whole. Cyclical analyses can help illuminate this question, but need to be treated with caution – they have a wide margin of error, because while economic cycles can be discerned in retrospect, it is virtually impossible (except by chance) to predict the duration of a boom or downturn while it is underway.

Options for preparing more comprehensive sustainability reports could include:

- a) Amending the *Charter of Budget Honesty Act 1998* to make the Intergenerational Report a responsibility of the independent fiscal agency, and broaden the coverage of that report (perhaps renaming it a Fiscal Sustainability Report); or
- b) Publication by the independent fiscal agency on a regular basis of long term forecasts and commentary to contribute to debate on fiscal sustainability. These could draw on, but not duplicate, the work of the Intergenerational Report.

3.3 Policy costings

3.3.1 Current practice

The *Charter of Budget Honesty Act 1998* provides for both the government and opposition to have policies costed by the Treasury or Department of Finance and Administration in the pre-election period. These provisions have been subject to criticism for their asymmetric affect: the government has access to the resources prior to the election being called, so can have all its policies in effect ‘pre-costed’, meaning it has little chance of being surprised by the results and (if the costs are too great) can amend its policies before they are released officially. The Opposition has no such access. The *Charter of Budget Honesty Act* also only mentions the Opposition; it does not contemplate costings being required by independents or minor parties.

In a statement of October 2005 titled ‘Operation Sunlight – Improving Federal Government budget reporting’, the then Shadow Minister for Finance Lindsay Tanner argued for fair access by non-government parties to resources to help them establish the costs of their policy proposals. He suggested that “there are benefits in giving equal access to costing resources well before the issue of writs for an election” and proposed that the *Charter of Budget Honesty Act 1998* be amended to “extend the period covered by the costing process to the 12 months prior to the last day on which election writs can be issued.” In government, as Finance Minister, Lindsay Tanner continued to pursue

Operation Sunlight reforms. He commissioned former Senator Andrew Murray to conduct a review, which was released in December 2008.

Senator Murray drew attention to potential challenges under the Charter of Budget Honesty arrangements:

“additional costing access will require increased resources. More difficult to resolve are potential conflicts of interest. On the plus side, allowing the Opposition access to Government departments for costings a year out from the election would be good for policymaking and allow the major parties to enter the caretaker period on a more equal footing. On the negative side, potential conflict could arise for the public service if it had to balance two simultaneous requests from the Government and Opposition... the current approach of receiving requests via the Prime Minister would not be appropriate... Related to the confidentiality of the costing requests, further conflict for the public service could arise from meeting with the Opposition.”

He also noted that:

“While the current system provides for the Opposition to obtain policy costings, at least potentially, it makes no provision for the needs of minor parties to do so... Minor parties are doubly disadvantaged; their inability to seek costings during elections is exacerbated by the lack of staffing resources with which they typically operate.”

He recommended that “the Government implement the changes to access for election costings proposed in Operation Sunlight, and investigate options to make provision for reasonable access to these services by minor parties.”

In response to the need identified for costing resources the May 2010 Budget announced that “The Government will provide \$0.5 million in both 2010-11 and 2013-14 to enhance the capacity of the Parliamentary Library to assist non-Government parties in developing policies in the lead-up to federal elections”.

To give effect to the measure the Library established the Pre-Election Policy Unit, from 1 July 2010, which provided assistance to parliamentarians in the lead up to the election. That service was evaluated⁹ and found to be successful within the limited time and budget available, but it would be more valuable to the policy development process if parliamentarians had access to this or a comparable service on an ongoing basis.

⁹ The report is available online at <http://www.aph.gov.au/library/pubs/PEPU/index.htm>.

3.3.2 Options for the future

Most interviewees saw costing as the most problematic function for a new body (which most interviewees assumed would be a Parliamentary Budget Office) for two reasons: the politics surrounding costings and the resources required.

Costing of political parties' policies is inevitably high profile and highly disputed. In the event that the function were given to the independent office, there would have to be some mechanism put in place to ensure that its costings did not conflict with published Treasury/Finance costings. Neither the independent body nor the two departments would welcome being dragged into a political fight over whose costings were more accurate. It would drag down reputations on both sides of the fight.

There is a difficulty for the public service in becoming involved in costings outside of the caretaker period (the period after an election is called, when the public service is meant to operate in 'caretaker' mode against the possibilities that either the government will be re-elected or a new government will be elected). Outside that period departments work for their Minister – and so providing assistance with costings to other parties is difficult, for the reasons identified by Senator Murray (see above). If an Opposition requested assistance in developing its policies in an iterative fashion – that is, submit a draft, see how much it cost, revise it and resubmit and so on – then it would need a very firm assurance that this process and any draft proposals would be kept secret from the Minister; but for the public servants concerned, keeping secrets from their Minister is an uncomfortable position to be in.

The resources involved in costings are also considerable. In the period when Charter of Budget Honesty costings are undertaken literally hundreds of public servants are involved – not only in Treasury and Finance, but also in other agencies. Some costings are very complex – for example, any proposals to change social security arrangements requires highly detailed specification, and then has to be tested through the very large and complex model of how the system works that is maintained by FAHCSIA, in consultation with Finance. It would be highly costly – and probably impossible – to replicate that expertise.

This is not an easy question to resolve. One possibility would be to give full responsibility for all policy costings – including Charter of Budget Honesty costings – to the independent body. This would not be favoured by Treasury or Finance. It would also require the independent body to be able to compel Treasury, Finance and other departments to provide the information necessary to cost the policies.

Another possibility would be for the independent body to act as an intermediary between parliamentarians and the departments in costing outside the caretaker period – preserving anonymity in relation to requests, but leaving the costings to be done by the departments concerned using their normal methodologies. This could still involve potential difficulties in the event that a non-government politician released a policy based on such costings and the Treasury or Department of Finance then disagreed with it under the Charter of Budget Honesty process. It would be possible though to provide a

mechanism to ensure that where changes that resulted from changed assumptions or the lapse of time, these differences would be spelt out in the official costing. It is an option that would need to be managed carefully to preserve trust and confidentiality, and would rely on strong communications between the new independent office and the key departments concerned.

Although costing is important for good policy development, all interviewees were of the view that it should not be the primary focus of an independent fiscal agency. If it were to become predominantly a free costing resource for non-government political parties its value to better fiscal management in Australia would be minimal.

3.4 Program evaluation

3.4.1 Current practice

The Commonwealth government in the past had a requirement that all programs should be subject to an independent evaluation at least every three years. In 1996 this policy was discontinued, for a number of reasons. First, market testing was seen as a more effective mechanism for assessing the worth of government activities. Second, the strategy itself was becoming worn over time: evaluations were often seen as lacking independence, agencies were lax about complying with the timetable requirement, many programs were missed, and many of the reports were either not published or published in obscure and difficult to access locations.

Various mechanisms are still employed for program evaluation; however, few reports that reach the public domain have a specific focus on value for money. The current mechanisms include the following:

- The Australian National Audit Office (ANAO) conducts performance audits that in some senses have a similar function to an evaluation, albeit within an audit methodology framework and avoiding questions of policy, which the ANAO sees as matters for government.
- The government itself commissions external program evaluations in some cases (a recent prominent example being the evaluation of the Building the Education Revolution program).
- The Parliament conducts inquiries into particular areas of interest.
- The Productivity Commission may be asked to undertake evaluations on specified areas of government activity.
- Departments themselves may commission external evaluations of particular programs. Under s.44 of the *Financial Management and Accountability Act 1997*, chief executives of agencies are responsible for proper use of resources, defined as “efficient, effective and ethical use that is not inconsistent with the

policies of the Commonwealth” – those who take this obligation seriously are generally supportive of external independent evaluations.

- Evaluations or program reviews may be commissioned from agencies during the budget process, often with the involvement of the Department of Finance and Deregulation, to inform future years’ consideration of budget bids.

This is a crowded area of activity in terms of ex-post (after the event) reporting on program performance. There is however a gap in relation to the key fiscal priority of achieving best value for money in government spending. In that regard there are limitations to all of these avenues for program evaluation.

Most of the current mechanisms are not well suited to examining large systemic issues that cross departmental boundaries (such as urbanisation, population, social disadvantage, investment attractiveness, international competitiveness, and costs of tiers of government). These can be examined through the inquiry processes undertaken either by parliamentary committees or the Productivity Commission, but these are time consuming and resource intensive. There are thus limits to the number of programs that can be considered in this way. Inquiry-based mechanisms are also highly reliant on submissions received to provide the authority and justification for their conclusions.

Some of the mechanisms, including ANAO audits and many government commissioned inquiries, are backward looking. Although they can draw out lessons for the future, these lessons are couched mostly in terms of errors to avoid rather than policy changes that can deliver better value for money. The ANAO is also limited in the extent to which it can make comment on value for money in terms of government priorities. While it can consider the extent to which programs comply with legislated or regulatory frameworks and meet the objectives set for them, its reports do not comment on whether those objectives are a good means of achieving value for taxpayers.

Some areas of government spending have been ruled ‘off limits’ for outside evaluation for political reasons – for example, support through the tax system for owner-occupied housing, or growth over the past decade in spending on security and policing.

Most of the program reviews conducted inside government, especially if they relate to areas where potential savings can be realised, are kept confidential. In some cases this can be fiscally responsible, allowing government to take a decision without arousing special interests to campaign for a program to be retained; but in others it can become a means of keeping options out of the public arena and preserving those special interests instead.

In light of these limitations, there is a case for giving an independent agency responsibility for evaluating government programs with a view to better value for money. If it is to avoid duplication and overlap, the responsibility should be confined to significant areas of spending that would not otherwise be caught up in evaluation processes elsewhere in the Commonwealth. Some possible areas could include:

- Better targeting of social welfare payments, and the interactions between different elements of the social welfare system - in particular, examination of areas of rapid growth in spending such as disability support payments, and options for supporting payment recipients to return to work
- The costs of overlap between the Commonwealth and the States in health and education, and options for a clearer delineation of responsibilities
- Identification of the reasons for growth in public service staff to current levels (according to some measures, the highest on record, adjusted for changes in coverage¹⁰) and options to contain that growth.

These evaluations might not only be about areas where savings are to be made; for example, one priority could be consideration of how to fund increased investment in skills formation; another could be development of an approach to assessing value for money in competing areas of infrastructure spending that cross over between portfolios (e.g. tradeoffs between transport, communications, defence and housing infrastructure).

Box 5 – How an independent value for money evaluation might be carried out

Any fiscal scrutiny body should also demonstrate value money in its own practices. A possible methodology for an evaluation to be carried out by the body could be:

- Identify the area to be evaluated and the core problem to be examined, and post the problem definition online. Link to any previous reports or papers that have addressed the problem.
- Prepare and circulate discussion papers on options to solve the problem, either using own resources or on specific topics requiring subject matter expertise, potentially from one or more external bodies (academics, consultants, community groups or others).
- Seek commentary and drafting suggestions openly, either through open forums, on paper or online. As an online example, the wiki approach adopted in the recent Government 2.0 report proved highly effective.
- Independently assess the different inputs received, make a judgement on value for money aspects of the program concerned, and propose options to government on improving value for money in the future.

¹⁰ There are various ways to measure the size of the public service; see Parliamentary Library *Background Note* 'How many are employed in the Commonwealth public sector?' Joanne Simon-Davies 26 November 2010

3.5 Tax expenditures

3.5.1 Current practice

Tax expenditures are the various concessions (deductions, exemptions, offsets, deferrals and so on) offered by government to taxpayers, individuals and corporate, that reduce the amount of tax collected. Because they have a similar effect to spending programs – they provide a benefit and they reduce the budget bottom line – they are often called tax expenditures, a term coined by former US Treasury official Stanley Surrey.

In Australia, there is a brief outline of tax expenditures in the annual budget papers (at Appendix F to Budget Statement 5 in Budget Paper One, page 5-48 in the 2010-11 Budget Papers). A more comprehensive *Tax Expenditures Statement* is published by Treasury annually, before the end of January in each year. The *Tax Expenditure Statement 2009*, issued on 29 January 2010, indicates that “Total tax expenditures are estimated at \$102 billion in 2008-09, or around 8.5 per cent of GDP”.

This figure includes only tax expenditures that can be measured – there are others that cannot be estimated reliably. The largest tax expenditures that are quantified are concessions for owner occupied housing and for superannuation.

Despite being the equivalent to almost a third of total government spending (which amounted to \$324b in 2008-09) tax expenditures would be lucky to receive a hundredth of the attention given to budget spending. Their publication is generally relegated to interior pages or business sections of newspapers, and given little if any mention in electronic media news bulletins.

Tax expenditures are the unloved orphan of fiscal scrutiny, paid little attention and not well understood and analysed.

3.5.2 Options for the future

An independent office could have a valuable role in scrutiny of tax expenditures. It could help raise the profile of consideration of the various concessions now incorporated in the tax system, and compare their effectiveness with government spending programs.

It can often be the case that a tax expenditure and a direct expenditure directly substitute for each other. On occasion they can overlap or even potentially work in conflicting directions in relation to the same functional area of government activity. Careful scrutiny would show up the areas of overlap and make recommendations for how best to overcome them.

A useful option would be to incorporate regular review of tax expenditures in the remit of any independent fiscal office, in cooperation with Treasury and other agencies as required.

3.6 Budget and other economic briefing and commentary

3.6.1 Current practice

The annual budget is subject to commentary from numerous media outlets; in addition, large accounting firms and consultancies will often prepare their own media briefings for their clients. It is also analysed by academics with an interest in fiscal matters, by accountants seeking to understand changes in the tax system, and by interest groups that have sought funding.

There would seem at first to be little room for an independent fiscal office to add anything to this plethora of commentary. However, there is an example of independent analysis of a specific area of the budget that points to the possible value that an independent fiscal agency could provide. The work of the Australian Strategic Policy Institute in its annual review of the defence budget is an invaluable aid to those seeking to work their way through the complexities of this area (see Thomson, 2010). Although its main source of information is the budget papers themselves, the work helps readers understand what is in the budget, put it in context, and draw out implications. It also provides an analysis that brings out the significance of what would otherwise be simply figures in tables.

There is a good case for something similar in relation to the budget as a whole. It is clear from interviews conducted for the project that the budget is not well understood, including by parliamentarians who are required to vote on it.

A briefing that was able to explain its contents from a reliable and independent perspective would be welcomed not only by parliamentarians but by many others with an interest in government tax and spending.

There is a similar function to be performed in relation to other official papers including the Tax Expenditures Statement (see previous section) and the Mid-Year Economic and Fiscal Outlook.

It might also be valuable in the event of releases of new economic data released by the Australian Bureau of Statistics that showed trends at variance with official forecasts (for example, in relation to growth and inflation). In doing so it could also act as a corrective to the tendency among some commentators to take one month's set of figures – frequently subject to revision in the subsequent month – as cause for premature alarm or celebration.

Another possible advantage of provision of this service within an independent fiscal office would be to reduce the unexpected and often unpredictable workload reportedly placed on the Treasury by demands for briefing from the current parliament:

Box 6 – economic briefing demands on Treasury

Treasury secretary Ken Henry... claims Treasury Department resources are under severe stress.

This is as a result of the demands from independents and the Greens.

Dr Henry told a private gathering of senior ex-Treasury officials... Treasury was now at the beck and call of the independents and Greens, creating a huge strain on the capacity of the department.

...one attendee told The Australian. "Dealing with a hung parliament was placing enormous pressure on the department as the government demanded they constantly brief not only the independents but the Greens also. And such briefings were being conducted at incredibly short notice..."

'Treasury swamped by demands: Ken Henry'

The Australian 9 December 2010

3.6.2 Options for the future

An independent office or commission would be well placed to issue period briefings explaining the budget and other major economic documents to readers. This would assist in raising the quality of economic debate in Australia.

In addition to responsive commentary on official documents, the body could also issue discussion papers in its own right on key fiscal issues. These could be targeted to current issues of key concern to fiscal sustainability, or to the fiscal implications of proposals that were the subject of widespread discussion in the media.

One valuable function that could be performed by an independent body outside of government or the political arena would be to raise the profile of an important issue that might otherwise be neglected because it was not part of the immediate campaign priorities of major political parties.

This would also imply a need for active engagement with media and other mechanisms to disseminate information such as online policy forums, seminars and conferences.

4 Options for structure, location and governance

A key consideration is the need to avoid duplication and overlap between the new body and the Treasury, Department of Finance, ANAO, Productivity Commission and other government bodies. The discussion of possible functions in the previous section aimed to identify areas where these bodies are not currently active, or ways in which responsibilities might be transferred to a new independent agency. This section of the report examines structural options in more detail.

4.1 Structural options

There are many different ways to structure functions which a government or parliament wants to have performed – both within government, and through purchase of those services from outside. The choice of structure and governance arrangement should be determined by the purpose for which it is intended (Bartos, 2004). As noted by DOFA (2005) “a clear and unambiguous purpose is fundamental to designing effective governance arrangements”.

Any independent fiscal body – whether a PBO or Commission of Budget Integrity – will have a number of possible functions it could perform. A key starting point in deciding which of these functions are appropriate and where they should be housed is to ask what purpose they are intended to fulfil.

If the primary purpose is to provide support for parliamentarians in their consideration of legislation and policy, then a governance arrangement based on parliamentary structures is appropriate: the Parliamentary Library model (either as a unit within the Library or a separate unit working alongside the Library).

If the primary purpose is to support policy making by government– while retaining a degree of independence – then a separate agency within government is appropriate: the Productivity Commission model.

If the primary purpose is to foster public debate and understanding of fiscal issues, and act as an external source of scrutiny, then a body outside government would be appropriate: the ASPI or NATSEM model.

An approach that will not work well would be to attempt to achieve all of these purposes within the one body. What the Canadian experience shows is that an independent fiscal office needs to have a clear, explicit and unambiguous mandate, and a structure that matches its mandate.

While some goals might be met as an adjunct to achieving the body’s main objective – for example, briefings to parliamentarians might also be made available to the public, or

conversely reports published to assist in public debate would also assist parliamentarians – it should be clear what the primary objective of the body is to be.

A further attribute of the body has to be independence. This is vital if it is to contribute to better economic management, public trust and good governance as outlined in Section One of this report. As noted by Hagemann (2010) “The effectiveness of fiscal councils hinges on several factors, including having full autonomy within the scope of their mandates, active and unfettered dissemination of their analysis and their credibility.”

Some possible structural options inside government (for example, establishing a fiscal scrutiny office as a branch within Treasury), although feasible, do not achieve this objective. They are therefore not considered.

Four options that would achieve the designated objectives are as follows:

- 1) Provision of a fiscal advisory service from inside the Parliamentary Library
 - Advantages: access to a pool of other researchers for tasks as they arise; established culture of independence and integrity; could be done without legislative change; pre-existing governance arrangements could apply.
 - Disadvantages: the priorities are likely to be driven by immediate parliamentary requests rather than underlying economic importance of issues; the body would be at risk of budget cuts (as in Canada); lack of own legislation undercuts its independent status
- 2) A separate independent parliamentary department
 - Advantages: meets concerns of parliamentarians in current environment (agreement with Greens); preserves independence from the executive (as in the US CBO); could establish a constituency of parliamentary supporters of the office
 - Disadvantages: as with 1, still driven by parliamentarians’ requests for advice and assistance; may be under pressure not to publish information provided in confidence to clients; may not have capacity to undertake independent program evaluation.
- 3) A separate Commission of Budget Integrity inside government
 - Advantages: a highly arms length and independent option. Would provide a high degree of transparency in resourcing and work program. Able to undertake work on the basis of economic judgement and advice. Would enlist a broader constituency in business and community groups.
 - Disadvantages: Could be subject to attack from other agencies (for example, the former Economic Planning Advisory Council always had an uneasy relationship

with the Treasury); would need strong governance through an independent Board.

- 4) A separate Commission of Budget Integrity funded by but outside of government.
 - Advantages: the most arms length and independent option. Would allow the body greater flexibility to engage on controversial issues. Would undertake a wide range of work on the basis of its own judgement and independent advice, and not be driven by either government or Opposition priorities. .
 - Disadvantages: As with option 3, could be subject to attack from other agencies and would need strong governance through an independent Board. Could be vulnerable to government withdrawing its funding if it produced reports critical of government.

Each of these options is outlined in more detail below.

4.1.1 Fiscal advisory service inside the Parliamentary Library

Under this option a fiscal advisory service could be established as a unit within the Parliamentary Library. This was an option favoured by some interviewees, primarily on the grounds that the Library has a strong culture of impartial, well researched advice. It will be important for the credibility of any new agency that it rapidly establishes a comparable reputation – as noted by one interviewee, perceptions of this kind of body are quickly set in concrete. Location inside the Library will predispose the body to have a similar culture and approach to its work. Other advantages include administrative ease of establishment, and that no new governance arrangements will need to be devised.

There were also misgivings expressed about the option. Some interviewees considered that it would be more difficult to recruit staff with high level fiscal policy skills and experience to a body that was not perceived as having a specialist and high profile economic advisory role. The location in the Library might also inhibit the body from taking a strong position on issues – for example, in a situation where it held a firm view that a future government’s budget position was unsustainable, it would still feel compelled to present a balanced range of views on this question including the official government view. It would also be less likely to engage in public debate; while the Library plays a commendable role in encouraging vigorous debate, Library staff themselves do so rarely and instead let their reports speak for themselves.

The closest international parallel to this arrangement is the Canadian Parliamentary Budget Officer, located within the Canadian parliamentary Library. There is ongoing tension in the arrangements in Canada, because the present PBO considers that a condition of the office is that it has a separate and independent role that is not required to report through the Librarian. If a similar arrangement were put in place in Australia, it would be desirable to specify reporting arrangements and accountabilities from the outset, before any appointments are made.

This is a model that would be well suited to provision of confidential briefing material to parliamentarians. That was however one of the sources of friction in the Canadian case, where the Parliamentary Budget Office took the view that all of its work should be made as transparent as possible, and was not comfortable with keeping information exclusively for the use of requesting parliamentarians.

One trap to avoid would be for the body to be dedicated solely to policy costings. As noted in section 3.3.1 above, the Parliamentary Library established a pre-election policy unit in 2010, to commission modelling reports to aid in the costing of non-government parliamentarians' policies. It would be easy for a body within the Library to assume its role was to continue this function and not provide analysis on other fiscal questions.

Governance

An independent parliamentary budget officer position could be created, reporting to the Parliamentary Librarian. The Librarian is a statutory office established by s38A of the *Parliamentary Service Act 1999*, appointed by the presiding officers of the parliament (the Speaker of the House of Representatives and the President of the Senate) for a 5 year term. The Librarian reports to the presiding officers and to the Joint Standing Committee on the Parliamentary Library.

There would be no barrier to creation of a position of a Parliamentary Budget Officer within the Parliamentary Library, with appropriate resourcing provided through an increase in the appropriation provided to the Department of Parliamentary Services. It would in effect amount to establishment of an additional arm of the Library providing specialist services in relation to fiscal matters.

4.1.2 Fiscal advisory body as a separate organisation within the Department of parliamentary Services

This would see the body established as a separate unit within the Parliament, of equivalent standing to the parliamentary Library. It could be established within the Department of Parliamentary Services, in the same way as the Parliamentary Library is part of that Department but largely autonomous in its operations. Physically it could either be located in Parliament House or in close proximity.

Establishment of the Office in this way would give it greater independent status, including through its own sections of legislation, and ensure that the Parliament spelt out clearly the purposes for which it was intended. It would have greater autonomy over its resourcing and staffing, which might be an advantage in creating a cadre of specialist fiscal analysts (although some interviewees commented that this could be a disadvantage, limiting the kind of thinking and perspectives provided through the Office).

The disadvantage would be creation of potential barriers between it and the Parliamentary Library on issues where cooperation would be desirable, and the need to establish its own culture and ways of operating without ready templates and examples to draw on.

The closest international parallel is the United States, which has a separate Congressional Budget Office and a Congressional Research Service that both operate autonomously providing services to Congress. There are some areas, such as provision of briefing on bills, where they work together to provide complementary services, the former providing estimates of costs and the latter analysis of policy implications.

Governance

This option would require amendment of the *Parliamentary Service Act 1999* to establish a separate Parliamentary Budget Office, and specify its functions and its accountabilities. The process for appointment of a Parliamentary Budget Officer could be the same as for the Parliamentary Librarian, a responsibility of the Presiding Officers. It could have a reporting line to a committee of the parliament; an obvious candidate would be the Joint Committee on Public Accounts and Audit, or alternatively the Parliament might consider creation of a separate committee on fiscal affairs.

4.1.3 Fiscal policy agency within government.

A frequent device used within government to promote arms length consideration of important issues is the establishment of agencies either inside a department with separate branding and identity, or outside the core department but within a Minister's portfolio, that have an independent role.

Examples at the Commonwealth level include the Productivity Commission, Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES), and Bureau of Infrastructure, Transport and Regional Economics (BITRE).

Past examples include the former Economic Planning and Advisory Council (EPAC), which became part of the newly established Productivity Commission in 1998.

The advantage of creating a new Commission of Budget Integrity in this form would be an arms-length relationship with the Parliament. Rather than its workload being driven by requests for briefing from parliamentarians, it could have a more strategic focus to a workplan.

The option of establishing the body inside a government department (e.g. the ABARES within the Department of Agriculture Forestry and Fisheries Australia) is that it lacks the formal independence of a body with its own appropriation and legal form. It means that its location and organisational form can be shifted around internally within a department (for example, the former Australian Bureau of Agricultural and Resource Economics was amalgamated with the former Bureau of Rural Sciences in 2010 to form ABARES) and its CEO is part of the departmental executive structure. There are advantages in terms of flexibility and possible savings in terms of corporate support services, but these are outweighed by the disadvantage that the body would face possible abolition any time it produced reports at variance with official government policy.

A more arms length relationship, such as that enjoyed by the Productivity Commission, would allow the body the freedom to provide independent reports and commentary. This is a position that could also be of considerable assistance to government in encouraging debate on reform options. The independent body would be able to raise awareness of uncomfortable or difficult fiscal questions and propose tough options for dealing with them, without the government necessarily having to take sides in that debate or commit itself prematurely to unpopular causes.

Governance

The two options for creation of bodies in the Commonwealth government are the *Financial Management and Accountability Act 1997 (FMA Act)* and the *Commonwealth Authorities and Companies Act 1997 (CAC Act)*. Both Acts can allow for a body to have a high level of independence operationally. The main difference is that *CAC Act* bodies have a governing board, control their own assets, have a degree of independence from other government policies and generally have the power to engage staff outside the *Public Service Act 1999* (see DOFA 2005).

Given that a Commission of Budget Integrity would want to have a high level of autonomy, and a strong Board to provide guidance and direction, a *CAC Act* form would seem the most appropriate route. This would also allow the body to undertake work on a commercial basis if opportunities arose. The Finance department prefers the form of *CAC Act* agencies to be a statutory body – that is, established through an Act of the Parliament – rather than a company. Not only because of this preference, but also in light of the purpose of the body as a provider of independent analysis and reporting, a separate legislative foundation would be desirable.

There is an alternative option, which would be to establish the Commission under the *FMA Act* and with its own legislation, but with statutory independence and a reporting line direct to the Parliament rather than through a Minister. This is the model that applies to the Australian National Audit Office, another key integrity institution of the Commonwealth, under the *Auditor-General Act 1997*. The Auditor reports to the Joint Committee of Public Accounts and Audit.

4.1.4 Fiscal policy agency outside government

A Commission of Budget Integrity need not be created within government directly. It could be created either as a Commonwealth owned company, or as a unit within a tertiary institution with sufficient budget funding to allow it operate on a continuous basis.

There are a number of instances of bodies outside government that maintain strong links with government and provide independent services.

One example is Education Services Australia, a national not for profit company jointly owned by education Ministers of the Commonwealth, States and Territories. It operates at arm's length from any specific government, is commissioned to undertake work by a

Ministerial Council, and has a board comprised of a mix of independents (including an independent chair) and representational appointees.

The National Centre for Social and Economic Modelling (NATSEM) is a research centre for economic and social modelling at the University of Canberra. Its primary source of income, through various indirect means, is from government, in the form of both grants and commissioned research. It was established by Dr. Ann Harding, a former Commonwealth public servant, in 1993, with the encouragement and support of her previous employer. NATSEM took on a modelling role that in some respects had previously been done in the then Department of Social Security, with the advantage of greater freedom to undertake independent research outside of public service restrictions.

The Australian Security Policy Institute is probably the most interesting recent development in creation of an independent agency outside of, but with strong support from, government.

Box 7 – the ASPI model

From the outset there was a very deliberate strategy of creating policy contestability between ASPI and the Defence department.

In his letter to the initial board members, then Minister Peter Reith said “The Government believes that contestability of advice is an important contributor to good public policy, and is concerned that in the strategic and defence policy arena the range of alternative views on which the government can draw is not well developed. ASPI is intended to help remedy this”.

ASPI relies on cooperation with Defence for the information required to do its job well; for that reason, it has depended on having high level supporters in the offices of both the senior and junior Ministers for the portfolio and at senior levels within the Defence hierarchy. Ministers' continued very strong support for ASPI has been essential to its survival.

One of the other elements behind the desire for an ASPI was that there was an increasing amount of ill informed debate on defence policy in the community, especially in light of Australia's international strategic stance at the time. Defence itself (being part of government) was not a credible source of counterbalance to the debate in public arenas and ASPI was seen as having an important role in injecting thoughtful, balanced analysis into the national policy debate.

ASPI receives the majority of its funding from the Commonwealth government through the Defence budget. It is a company limited by guarantee under the *CAC Act*, wholly owned by the Commonwealth. It has its own independent Board.

Since the creation of ASPI, reportedly (although this is purely anecdotal) the strategic policy advice provided by the Defence department itself has also improved markedly.

Table 2 – matching form to function

	PBO inside Library	PBO in Parliament	Fiscal advisory agency within government	Fiscal advisory agency outside government
Confidential briefings to MPs & Senators	***	**	*	*
Macro Forecasting	*	*	**	*
Assurance on forecasts	*	*	**	***
Costing of policies	*	**	***	**
Sustainability reporting	***	**	**	***
Evaluations	*	*	***	**
Comment on budgetary and economic policy issues	**	**	*	***
Published reports and discussion papers	**	**	**	***
Contributions to media and external debate	*	**	*	***

* Moderately Suitable

** Suitable

*** Highly suitable

4.2 Workload, budget and staffing

Other key considerations for the new body are how its functions translate into a work program, what resourcing it will require and how it should be staffed.

4.2.1 Work program

A potential danger for the body is that its work program will be reactive, driven by immediate events and requests (especially if it is located within the Parliament) and not have the capacity to develop original thinking on key fiscal challenges facing Australia.

This is a perennial problem even within departments such as Finance and Deregulation, where the annual budget cycle with its continual round of estimates updates, briefings and publications tends to drive out longer term thinking. This led that Department to create the long term budget policy unit precisely to avoid the problem of policy being purely reactive.

In a Parliamentary Budget Office there is also the timetable pressure of the political cycle to contend with, which would affect workloads associated with costing of election proposals.

If a Commission of Budget Integrity were established with an independent Board, an important role for the Board would be to set priorities and ensure that forward looking analysis of key issues was undertaken.

Whatever the structure chosen, it would be desirable for the body to agree an annual work program with either the parliamentary committee or Board to which it reports. That would be published online, and the body would be responsible for publication of progress reports against that work program.

4.2.2 Staffing

This was the area of most concern among stakeholders consulted for the project, including overseas independent fiscal advisors. The skill set required for an office of this nature is not common. It requires staff with the capacity to understand budget documents, analyse fiscal issues, and then present reports in a way that allows non-expert readers to understand and apply the information.

Finding suitable staff will be a challenge for the new agency. The most obvious sources of people with the necessary skills and expertise are the Departments of the Treasury and of Finance and Deregulation – but neither will be very comfortable with losing key staff to an independent agency. There are though alternatives, including secondments and temporary placements, which can overcome this problem. Ideally, the independent fiscal agency would become known as a good stepping stone in the careers of talented economists and budget analysts, exposing them to work they would otherwise not be able to do inside a department of state.

The body should also have the authority and resources to obtain services on a consultancy basis to meet short term demands or in order to prepare briefing and advice in areas of specialist expertise.

4.2.3 Funding

The decision on levels of funding will be up to the government and Parliament, depending on the role they perceive as appropriate for the new body. An indicative outline of the kinds of roles that might be supported is below.

Table 3 – Funding a PBO or Commission of Budget Integrity

Funding level	Number and type of staff and other resources	Scope of activities
\$3m	Around 10-12 staff, one SES, no Board, limited IT, limited access to information, use of existing websites (e.g. in the Parliamentary Library) to disseminate information	Mainly advisory, handling ad hoc requests, costing of proposals, commissioning a limited amount of external research
\$10m	Around 30-40 staff, 2 senior executive, Board, access to journals and online databases, own website, access to frequent consultancy or research advice	As above, plus stronger role in economic forecasting and commentary, some examination of government spending programs
\$20m	Around 60-80 staff, high powered Board, library resources (mainly online), interactive website to encourage extensive public engagement, strong publications capacity, strong IT capacity to support modelling and analysis.	As above, with a significant research capacity, ability to scrutinise government programs, searching examination of underlying fiscal and budget issues and scrutiny of the full range of revenues, expenses and tax expenditures

These figures are derived from a comparison with a variety of other Commonwealth bodies: the Productivity Commission (expenses \$38.8m, average staffing level 190); National Water Commission (\$21.3m, ASL 50); Australian Office of Financial

Management (\$9.6m, 37 ASL)¹¹. They also take account of overseas experience, although direct comparisons are not possible due to different accounting and budgeting methodologies between countries.

Staffing levels vary considerably depending on the nature of the work undertaken, the extent to which use is made of resources other than public servants, and availability of economies of scale. This makes inter-agency comparisons, especially between agencies of different size, fraught with potential for misinterpretation. The figures presented are only indicative, and a detailed costing of the office would have to be developed were it to proceed, taking account of the mandate and functions agreed for the body.

It should be possible to fund the agency through savings elsewhere in the budget. Moreover, to the extent that an independent fiscal agency enabled consideration of areas of comparative fiscal neglect, it could be expected in any case to result in a net positive benefit to the budget balance over time.

4.3 Comparing the options

Determining the appropriate functions and therefore structure for the independent fiscal agency will involve tradeoffs between different priorities. Discussions to date have focused largely on its potential role in support of parliamentarians; however, as noted with commendable self awareness by one staff member of a parliamentarian “we can sometimes be too inward looking and think that this [Parliament House] is the only place that matters”. The contribution of the independent office to better budget management will have broader benefits to all Australians.

In that light, the criteria for determining what functions are most important (and therefore how the body should be structured) could focus more on what added value it would bring to national fiscal performance. One way to do this would be to ask what function it could perform that is not presently provided through other institutional arrangements. Against this test, the functional priorities would be preparation of fiscal sustainability reports, independent validation of economic forecasts, and evaluation - from a value for money perspective - of neglected or problematic areas of government activity.

¹¹ Source: *Budget Paper No. 4 2010-11*, Agency Resourcing, and Table C:5 Estimates of average staffing level (ASL) of agencies in the Australian general government sector, Appendix C, Budget Paper 6, *Budget Paper No. 1 2010-11*. Australian Government, Canberra

5 Attachments

Attachment A

Proposals for independent fiscal offices in Australia

There has been a sporadic debate in Australia on the need for an independent fiscal agency, in various forms and for different purposes, over at least the past ten years.

Economist Nicholas Gruen (1997, 2000, 2001) has been a long time advocate for the creation of an independent fiscal policy agency within government with the kind of institutional independence enjoyed by the Reserve Bank in relation to monetary policy, to determine annual targets for the discretionary use of fiscal policy by governments. This was a theme also taken up by the Business Council of Australia (1999) in the context of a broader discussion paper on economic management.

In a 2003 paper on fiscal rules Ric Simes of the Chifley Institute argued for the creation of an independent ‘Institute for Fiscal Affairs’ charged with “monitoring the performance of fiscal policy against the Government’s fiscal rules and principles; conducting research into policies relating to intergenerational matters; and promoting debate on how various policy agendas interact with fiscal policy”. He proposed this be established outside government, through a tender process.

Carling and Kirchner (2009) argued that the Charter of budget Honesty had failed to restrain growth in government spending and debt, and argued for creation of a Fiscal Commission “to enhance the independence, transparency and accountability of the federal budget process”. An innovative aspect of this proposal was that “The Fiscal Commission would enforce compliance with the fiscal policy rules...and have powers to impose pecuniary penalties on members of the federal parliament for non-compliance... A one percentage point breach of the budget balance, net debt, or expenditure and revenue shares of GDP would be penalised on each count by a 1% reduction in politicians’ remuneration...”. Aside from the punitive powers, the arrangement proposed has some features in common with a number of European fiscal Councils.

More recently, there has been considerable debate around the creation of an independent Parliamentary Budget Office (PBO). While this debate has been given additional impetus by the agreement reached with independent MPs as part of the formation of the current government, it had been discussed in various forums previously and was a prominent Coalition policy commitment¹² in 2010.

¹² Media Release, Andrew Robb MP, *Coalition to Ensure Taxpayers Get Better Value for Money* 23 June 2010.

Attachment B

European independent fiscal advisory bodies.

A summary of the arrangements applying to a number of European fiscal councils or equivalent bodies is set out below. It draws extensively on the excellent website on fiscal councils developed and maintained by Prof. Simon Wren-Lewis at Oxford University, supplemented by materials derived from the websites of individual countries' Councils.

Netherlands

The Netherlands Bureau for Economic Policy Analysis (CPB) was founded in 1945. It is an independent research institute and has its own independent external advisory body. It provides economic and fiscal forecasts as inputs into the budgetary planning process. It also evaluates the election programme of government and opposition parties (at those parties' requests). The Bureau also provides economic expertise on a wide range of specific issues, such as labour market reform.

Denmark

Denmark has had an Economic Council since 1962, joined more recently in 2007 by an Environmental Economic Council. The two Councils have a common chairmanship of four senior professors –the Councils' website notes these chairpersons are usually called the "wise men". The Councils each have 17 members. The members of the Economic Council are drawn from government, the Danish Central Bank, academe, unions and "employers federations" (although some of the latter would be more akin in Australia to industry lobby groups). The membership of the Environmental Economic Council is similar but also includes environmental non-government organisations.

The objective of the Economic Council is "to monitor the Danish economy and analyze the long-term economic development. Another objective of the Council is to improve coordination between the different economic interests in the Danish society. Therefore the Council plays an important role in the public debate on economic policy issues in Denmark"¹³.

The Economic Council meets twice a year, and the Environmental Economic Council meets once a year. The Economic Council considers reports from the Chairmanship which contain medium term economic forecasts for the Danish economy and special analyses of selected topics such as labour markets, the welfare state or the European Monetary Union.

¹³ From <http://www.dors.dk/sw3018.asp> viewed 6 December 2010

The Councils are supported by a secretariat of 20, mainly economists or environmental economists.

The approach reflects differences in Nordic systems of governance that emphasise greater consultation across society, and joint decision making between government, unions and employers (often described as a ‘corporatist’ approach to government). This kind of tripartite decision making has been a feature of specific areas of policy making by some previous Australian governments, but has never been institutionalised to the extent it has in many Scandinavian countries.

Belgium

The Federal Planning Bureau, established in 1994, provides a range of services along similar lines to the CPB in the Netherlands. In addition, the High Council of Finance, which was reformed in 1989, oversees the coordination of regional and national fiscal policy. It sets medium term objectives for regional and national budget deficits, and proposes annual targets, which form the basis for government negotiations. The High Council is chaired by the Minister of Finance, but has representatives from inside and outside government. Although it has no formal decision making power, it does exert considerable influence.

Sweden

The Swedish Fiscal Policy Council, established in 2007, has small resources but a broad remit. In addition to monitoring the long-run sustainability of fiscal policy, the council evaluates the short-run fiscal stance from a cyclical perspective. The council also analyses long-run employment and growth developments. Another task is to evaluate the motives, explanations and research basis for government policies. The council plays a “supervisory” role in the country’s general economic policy debate, helping to raise the standards of discussion.

As in Denmark, the leading role played by the Fiscal Policy Council in economic debate is a reflection of the greater consensus tradition in Swedish governance. It may not be a function easily translatable to the more adversarial Australian political system.

Hungary

The Fiscal Council of the Republic of Hungary was set up in 2009 as ‘an independent state institution that endeavours to ensure the responsible management of public resources.’ It prepares macroeconomic forecasts which represent the baseline for budgetary decisions. It also provides comment and advice on fiscal planning more generally, within the context of existing fiscal rules.

Slovenia

A Fiscal Council was established in 2009 “as a consultative body for independent assessment of the fiscal policy and implementation of structural reforms”. Its tasks include assessment of: the sustainability of fiscal policy, efficiency in the use of public

funds, trends in revenue and expenditure, transparency in finances, the quality of economic forecasts, borrowing and guarantees.

Its establishment followed a proposal advanced in the 2009 OECD Country Survey of Slovenia, which argued that “the rationale of a fiscal council is that it mitigates the information asymmetry problem between the government and its electorate and hence it helps the electorate to judge the government’s fiscal decisions” (a rationale that can be applied more broadly to independent budget commissions or offices in any country).

The members of the Fiscal Council are appointed by the Government and include economists, bankers and a former head of tax. It is not yet clear how broadly the body will interpret its mandate and whether or not it will undertake fundamental assessment of government; its main products appear from press reports to have been fiscal updates.

Attachment C

Review of fiscal agency literature

Inspired partly by the success of delegation in monetary policy, fiscal agencies now form a strong feature of a comprehensive macro-prudential framework in a growing number of countries. This attachment presents a summary of the recent literature on fiscal agencies, with a focus on:

- their benefits and disadvantages compared to other fiscal instruments (section 1),
- their potential impacts on accountability and transparency in government and informed public debate (section 2), and
- the key features of such agencies (section 3).

This paper was prepared by Carole Canler of the Auckland office of the Sapere Research Group. It is strongly inspired by a recent literature review on independent fiscal agencies conducted by Debrun, Hauner and Kumar at the International Monetary Fund.

Section 1 - Comparison of fiscal instruments

The lack of fiscal discipline in many countries has been a strong focus in the literature, even more so recently following the financial crisis. It is argued that policy makers tend to focus primarily on the short-term consequences of their actions. In addition, there is a possible conflict between political agenda of a constituency or group and fiscal restraint. A third factor is the time inconsistency - or lags in decision making and in implementing policy measures after a shock has been identified.

These factors create a bias towards over spending, giving way to public deficits and potentially procyclical policies. A number of different instruments and approaches have the potential to improve the incentives for policymakers to use discretion responsibly, reduce deficit bias and improve fiscal outcomes. They can be categorised as: fiscal rules, fiscal responsibility laws, and independent fiscal agencies.

The initial reaction to the problem of deficit bias, both in government and academia, was to explore the use of fiscal rules that might provide a constraint on governments¹⁴. Probably the most notable example is the Stability and Growth Pact of the Euro zone.

¹⁴ Fat'ás & al. (2003)

Fiscal rules have however not been very successful, in the sense that they have not been adhered to. One of the problems with fiscal rules is that simple rules are clearly suboptimal, but more complex rules are difficult to monitor. In addition, numerical rules might be simple but they come at a cost: lack of flexibility. Strict numerical rules on budget balances of government debt have the advantage of being simple and transparent. But because of their inability to adapt to changing economic conditions, they are likely to lead to credibility crises. There is an almost perfect parallel with fixed exchange rate regimes as simple rules to conduct monetary policy¹⁵.

Wyplosz¹⁶ compares rules-based with institution-based fiscal discipline, and strongly supports the latter over the former. He argues that institutions can have the flexibility that rules do not have, and can use judgment, which rules cannot.

His view is strongly supported by the literature, which suggests that rather than removing policymakers' discretionary power (through the use of rules for example), institutional reforms aimed at improving or correcting incentives would be preferable. They provide a framework and institutional guarantees that significantly reduce the likelihood that discretionary could be misused.

Section 2 - Accountability, transparency and credibility

Transparency of policy has been interpreted by fiscal authorities as referring to tracking how tax revenues get spent, achieving 'value for money' from government programmes, following accepted accounting standards, and conducting policy in an open and public way.

Fiscal transparency seems to be more about establishing the integrity of the fiscal process than it is about helping the public to form expectations of future tax and spending policies." Along many important dimensions, monetary and fiscal policies have more similarities than dissimilarities. Leeper¹⁷ argues that this is "the minimal standards that a democratic society should expect from its government".

The literature makes many parallel between monetary and fiscal policies¹⁸, both in terms of transparency standards and institutional frameworks. Monetary policies are scrutinised by legislators, economists and the public. This intense scrutiny has led the most transparent central banks to reveal to the public in written documents, public

¹⁵ *Ibid*

¹⁶ Wyplosz C (2002)

¹⁷ Leeper E M (2009)

¹⁸ Debrun & al. (2008)

speeches, and news conferences three key aspects of their decision making processes: the objectives of monetary policy and the means by which the central bank tries to achieve the objectives; the central bank's views of the current state of the economy, including its understanding of the sources of shocks to the economy in the recent past; and the central bank's forecasts of important economic variables, including at least some discussion of where future policy is likely to head.

Some authors recommend using monetary transparency standards as a benchmark for fiscal transparency¹⁹. They recognise that such a level of transparency might not be achievable, but that agencies should use those as targets. They argue that enhanced fiscal transparency can be beneficial in macro-economic terms. It can help anchor expectations of fiscal policy, raise the level of discourse about fiscal policy effects and financing options, and make fiscal actions more predictable and effective. Transparency reduces macroeconomic uncertainty by taking some of the guesswork out of policy intentions.

A question relevant to this paper is whether the separation between an institution, such as an independent fiscal agency, and the executive level improves public governance in terms of transparency, openness and accountability. Leeper argues that “the arguments that have led countries to make dramatic reforms to their monetary policy institutions apply with equal – or possibly greater – force to fiscal policy”²⁰.

Mihailov and Ullrich²¹ analyse the effects of fiscal (and monetary) agencies on accountability in the form of possible overriding by the government of economic policy decisions delegated to a committee of experts with mandates in the fiscal and monetary area. Accountability is only reasonable if the institution to be made responsible is sufficiently autonomous in the first place.

The authors test for different degrees of independence and interaction of the appointed committees, each taken in its entirety as a policymaking unit or agent, and the elected government, as principal. They then compare the equilibrium outcomes of these alternative institution-design frameworks compared and ranked according to key macroeconomic performance criteria such as inflation expectations, inflation, output and the budget deficit. The authors conclude that if the priority is to manage inflation and inflation expectations, a society should opt for independent monetary policy which is not constrained by the threat of its decisions being overridden, no matter whether fiscal policy is similarly independent or fully dependent. If, on the other hand, a society would prefer to mitigate the fluctuations of output and employment, policymaking by expert committees should be additionally constrained either by accountability mechanisms

¹⁹ Leeper E M (2009)

²⁰ *Ibid*

²¹ Mihailov A & Ullrich K (2008)

(such as override clauses or similar) or by permitting instrument but not goal independence as, for instance, in popular inflation targeting regimes of monetary policy. One can argue that similar rules could apply to fiscal agencies.

Section 3 - Role of independent fiscal agencies

The literature distinguishes between independent fiscal agencies, and fiscal councils, the difference being whether the agency's mandate includes policy development.

Independent Fiscal Agencies	Fiscal Councils
Set long-term objectives (e.g. debt targets) and short-term targets consistent with them (e.g. fiscal balance)	Provide objective analysis of fiscal policies
Set targets (for fiscal balance) in the context of a fiscal rule	Provide independent budget forecasts
Adjust some pre-determined tax and expenditure packages	Provide normative assessment and recommendations

Independent Fiscal Agencies can provide technical expertise and help inform, analyse, develop, assess and implement fiscal policies. Wyplosz²² argues that fiscal policies should be taken out of the hands of policymakers. "Democratic control is essential for deciding the size of government, the distribution of spending and the structure of taxation, but it has proven inefficient to set the size of the budget deficit. Taking the deficit and the debt out of the standard democratic process does not imply any loss of democratic control where it is fully justified. The macroeconomic aspect of fiscal policy is not different from that of monetary policy".

To date, however, no country has established an Independent Fiscal Agency. The fact that there is no existing Independent Fiscal Agencies suggests that "policymakers might be reluctant to delegate such a significant element of their policy mandate and that their implication may raise issues of democratic accountability"²³. Fiscal Councils are generally more acceptable and have the potential to improve fiscal discipline. We discuss below the potential mandate for a Fiscal Council, common institutional set-ups and lessons learnt in terms of their effectiveness.

²² Wyplosz C (2002)

²³ Debrun & al. (2008)

Mandate:

An important point in the literature is that the mandate of the fiscal agency depends on the severity of the fiscal problems, and the existing institutional framework. The Swedish experience shows that “the broader the remit, the more difficult it is to penetrate an issue in depth. But the appropriate tradeoff depends on the environment in which a fiscal agency operates”²⁴

A review of proposals to establish Fiscal Councils highlights three types of activities:

1. The most common function is to assess budgetary performance relative to fiscal rules and to suggest adjustments if necessary²⁵. This equals to a strengthening of the commitment to existing fiscal rules through a Fiscal Council type of institution. Fat’ás²⁶ concludes that “the lack of continuous short-term monitoring designed to ensure that the country will meet its loosely-defined long-term goal is likely to lead to loss of credibility”. In this respect, a Fiscal Council has the potential to remedy this shortfall. The OECD also argues that, in the context of tax reforms necessary to address growing public deficits, “there is often a role for independent bodies charged with assessing the likely impact of proposed reforms on taxpayer behaviour, revenues, equity and ease of administration”.
2. Some proposals go a step further and suggest combining a Fiscal Council’s assessment of the observance of fiscal rules with sanctions imposed by the judiciary²⁷. Ultimately, the idea is to make fiscal rules that were established through the political process legally binding like any other constitutional provision.
3. Some proposals suggest the independent preparation of fiscal and macroeconomic forecasts by a Fiscal Council²⁸. The OECD states that “the most significant risk to any fiscal strategy is the use of inaccurate economic forecasts, notably the use of “optimistic” ones which make additional revenue seemingly available and thus reduce overall discipline. The independence of the preparers of economic forecasts needs to be assured”²⁹. The use of separate independent bodies to prepare economic

²⁴ Calmfors L (2010)

²⁵ Committee on Stabilization Policy (2002), Fat’ás et al. (2003), European Commission (2004), Ubide (2004)

²⁶ Fat’ás & al. (2004)

²⁷ De Haan et al. (2004), Inman (1996)

²⁸ Jonung and Larch (2006), Ubide (2004) and Wyplosz (2005)

²⁹ OCEC (Nov 2010)

forecasts is a notable trend. Such bodies can also play an important role in assuring the observance of any fiscal rule.

The Fiscal Council would prepare forecasts on a continuous basis that could increase the transparency of the budget and of fiscal performance throughout the year. The essential difference between these forecasts and those by the private sector or academic forecasters would be that the Fiscal Council would be legally mandated, and would thus have both statutory obligations and full access to information on actual policy goals and motivations. The forecasts could be revisited during the year to adjust the fiscal stance where needed. While the ultimate decision on the budget forecasts could be left to the government, the impact of independent forecasts on fiscal discipline would be enhanced if their use for the budget were mandatory.

4. A potential fourth function is independent arbitration between the central and sub-national levels of governments. This assumes substantial fiscal decentralisation.

Institutional arrangements:

The proposed institutional arrangements for Fiscal Councils vary, but autonomy is a general consideration. Most proposals envisage that Fiscal Councils would consist of economic policy experts from academia and the public sector, whose autonomy could be bolstered by a number of provisions, not unlike those in place for many independent central banks.

Accountability could be enhanced if Fiscal Councils were instituted by parliament and required to explain recommendations in comprehensive public reports.

Moreover, a Fiscal Council's influence on policy and its contribution to public debate would depend on the credibility of its assessment. The credibility of the fiscal agency is paramount if it is to exert influence and contribute to the public debate.

Effectiveness:

The literature strongly emphasises that a Fiscal Council should have an explicit mandate, have discretion to fulfil its mandate, be accountable to the executive agencies using ex-post control, and be independent using explicit guarantees against ex ante political control.

Debrun³⁰ argues that a number of conditions could strengthen the effectiveness of a Fiscal Council, given that it would exert influence primarily through the public debate:

³⁰ Debrun & al. (2008)

- its mandate needs to be clearly defined and reflect a relatively broad social consensus on what constitutes sound policy
- the government must be willing to integrate the Fiscal Council into its work – perhaps even by using it to bolster its case for unpopular measures or reforms
- the existence of fiscal rules, because they provide a clear benchmark against which the government’s policies can be assessed
- a central role for the Fiscal Council in the budget process, for example the budget vote could require a hearing with the Fiscal Council or an explanation from the government if its recommendations are ignored
- legislated provisions regarding the Fiscal Council, because they could bolster its position in a possibly unfavorable political environment.

Fiscal agencies seem to work best when there is a certain degree of separation from the executive. In addition, a degree of public engagement is desirable. Fiscal Councils must insist that insight into fiscal decisions and their consequences, before political decisions are made, extends beyond the decision-makers and a narrow circle of experts, and should be open to the general public as well. This is broadly supported by the OECD³¹ which states that public policies, including fiscal policies, are more legitimate, credible and effective if they meet the expectations and needs of the people for whom they are intended. Well-designed public engagement helps to design and deliver effective public policy and services while strengthening trust in government. In addition, and because of their role to improve the public debate on tax policy, the Fiscal Council needs a high degree of credibility if it is to be effective. This is best achieved through independence, transparency and technical expertise.

Alice Rivlin³², the first director of the US-based Congressional Budget Office (CBO) provides some interesting insight as to the CBO’s effectiveness:

”CBO’s acceptance by the political players rests on four aspects of its structure and history.

- It has had strong professional leadership and attracted high quality analytical staff.
- It has been aggressively non-partisan and never allowed politicians to appoint members of the staff.
- It never makes recommendations on policy matters, but offers estimates of budgetary costs or analysis of options and alternatives. It has always tried to help politicians evaluate their choices and steadfastly refused to tell them how to choose.
- It makes all of its reports and analyses available to the public and the press and tries hard to make them clear and readable.”

³¹ OECD (2004)

³² Rivlin A M (2010)

Attachment D

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