CHAPTER 12: DEFINING FISCAL SUSTAINABILITY

The accrual GFS reporting standard provides a number of alternative indicators as bases for evaluating whether a government's present and probable policy settings need to be adjusted in face of likely budgetary developments. States too currently adopt a variety of different fiscal indicators and targets in this context.

This chapter explores the issue of fiscal sustainability further. It is Access Economics' conclusion that:

- fiscal sustainability involves a number of elements: policy sustainability, intergenerational equity and tax stability;
- of the available flow-type fiscal indicators, the net operating surplus and net borrowing indicators are both important;
- of the available stock-type fiscal indicators, the net financial liabilities indicator is the most useful (although capital markets continue to prefer the net debt indicator); and
- setting quantitative targets is an empirical rather than theoretical issue.

12.1 MEASURES OF A GOVERNMENT'S ANNUAL FINANCIAL PERFORMANCE AND POSITION

The specification of a government's fiscal targets depends importantly on the preferred *measure* of a government's financial performance or position. Fundamentally, fiscal targets rely on the choices made about which measure of the annual budget surplus/deficit and which measure of its balance sheet position best summarise a government's annual financial performance and position.

12.1.1 Key measures

There are three key measures of *annual financial performance* derived from a government's operating and cash flow statements:

- the **net operating surplus (+)/deficit(-)**: an accruals-based measure of the operating (or current) balance;
- the **net borrowing(+)/lending(-)**: an accruals-based measure of the *overall* fiscal balance (that is, taking both operating and capital activities into account); and
- the **cash surplus (+)/deficit(-)**: a cash-based measure of the *overall* fiscal balance.

Likewise, there are three key measures of financial position at the end of a particular financial year derived from a government's balance sheet:

- **net worth**, as measured by total liabilities (both interest-bearing and non-interest bearing) less total assets (both financial and non-financial);
- **net financial liabilities**, as measured by total liabilities (both interest-bearing and non-interest bearing) less financial assets; and
- **net debt**, as measured by the stock of interest-bearing financial liabilities (deposits held, advances received and borrowings) less the more liquid of financial assets (cash and deposits, advances paid and investments, loans and placement).

12.1.2 Underlying stock-flow identities

The measures of annual financial performance ('flow' measures) are related to various financial position ('stock') measures. *Stocks* refer to the holdings of assets and liabilities at a point in time,

valued at market prices prevailing at that time. *Flows* are economic events and other occurrences that cause changes in the value of stocks through the creation, transformation, exchange, transfer or extinction of value, recorded in a particular financial year on an accrual basis (i.e,, *between* points of time).

In turn, flows can be separated into transaction flows and revaluations. *Transactions* represent changes in stocks that come about as a result of the annual activities and policies of a government. *Revaluations* represent changes to stocks that arise from price movements, whether product prices, asset prices, interest rates or exchange rates.

The relationship between the three key flow concepts and their stock equivalents is as follows:

Table 12-1: Flow-stock identities

FLOW CONCEPT	STOCK EQUIVALENT
Net operating surplus(+)/deficit(-)	= change in net worth arising from annual transactions
Net borrowing(+)/lending(-)[a]	= change in net financial liabilities arising from annual transactions
Cash surplus (+)/deficit(-)	= change in net debt arising from annual transactions[b]

[a] Note, the usage here reverses the sign given to this concept in the GFS.

[b] This overlooks the role occasionally played by financial leases.

In turn, the relationship between the three key stock concepts and their flow equivalents is as follows:

Table 12-2: Stock-flow identities

STOCK CONCEPT	FLOW EQUIVALENT
Net worth	= opening net worth *plus* net operating surplus *plus* annual net worth revaluation effects
Net financial liabilities	= opening net financial liabilities *plus* net borrowing *plus* annual net financial liabilities revaluation effects
Net debt	= opening net debt *less* cash surplus *plus* annual net debt revaluation effects

The relative merits of these alternative stock and flow measures as a basis for specifying fiscal targets are discussed later in this chapter.

12.2 CURRENT FISCAL TARGETS AND MEASURES: A SURVEY

A government's preferred measures of its annual financial performance and position are most evident from an examination of its preferred fiscal targets.

12.2.1 Commonwealth

The Commonwealth's *Charter of Budget Honesty* requires the government of the day to explicitly outline its fiscal strategy. The present Government's medium-term fiscal strategy is to maintain budget balance, on average, over the course of the economic cycle. Within the strategy, the Government has identified supplementary objectives involving:

- no increase in the overall tax burden from its 1996-97 level;
- maintaining overall financial surpluses over the forward estimates period while economic growth prospects remain sound; and
- improving the net worth position over the medium to longer term.

More recently, in its *Intergenerational Report* published in May 2002, the Commonwealth has stated that achieving a zero 'underlying' cash surplus, on average, over the longer term would be consistent with:

- stabilising nominal levels of net debt, on the grounds that the 'underlying' cash surplus during a period is broadly similar to the reduction in net debt; and
- improving net worth over time.

The Report also noted that, while the Commonwealth does not have an explicit net debt target, net debt is to be maintained at prudent levels under the *Charter of Budget Honesty*. Achieving the fiscal strategy aims to result in a stable level of nominal net debt and a falling level of net debt as a proportion of GDP as the economy grows over time.

The fiscal *measures* currently preferred (as evidenced by the above targets, rather than statements about fiscal balances of underlying cash balances) by the Commonwealth are therefore the cash surplus/deficit as the flow measure and net debt and net worth as stock measures.

12.2.2 New South Wales

The current fiscal strategy of the New South Wales Government aims to ensure continuity of service provision, particularly during periods of economic weakness. This is to be achieved by:

- strengthening the State's overall financial position by reducing the State's net debt and other financial liabilities to sustainable levels;
- being forward-looking by anticipating demographic and other long-term pressures on the budget; and
- aligning the growth of government spending to sustainable revenue growth.

To meet these aims, the Government's fiscal strategy includes balance sheet management focusing on total State and general government net financial liabilities, and maintaining a tax regime that is conducive to business investment and enables New South Wales to be competitive with other States and countries.

The Government's key medium-term fiscal *targets* are as follows:

- to ensure the growth of expenditure is consistent with the growth of the revenue base which depends, in turn, for a given tax policy (set of tax rates, thresholds and bases), on the economy's sustainable growth rate;
- to maintain overall surpluses (net lending) during periods of buoyant economic and property market conditions, allowing deficits if necessary in weaker periods; and
- to lower the State's net debt and other financial liabilities to sustainable levels, at which the State's finances could absorb adverse shocks – such as a sharp fall in property-based revenue – without the need for disruptive expenditure cuts or tax increases.

The Government's overall fiscal policy takes into account the financial position of the State sector as a whole, including non-financial public corporations, on the basis that the financial position of these corporations can affect the general government sector.

The 'net borrowing' flow measure is recognised to be the link between the budget and 'net financial liabilities' stock measure. Although not the only determinant of changes in net financial liabilities, the Government acknowledges that it is the factor most directly within the control of the Government through policy choices. Other factors recognised as affecting net financial liabilities include actuarial revaluations of superannuation and other non-equity liabilities, and movements in market interest rates. The Government targets budget surpluses to help keep net financial liabilities on a falling trend.

Once net debt and net financial liabilities have been reduced to sustainable levels, the Government's fiscal strategy seeks to maintain surpluses during periods of buoyant economic and property market conditions, allowing deficits if necessary in weaker periods. The strategy recognises that actual tax revenue can be volatile and may deviate from a sustainable average growth rate for lengthy periods. Cycles for individual taxes are recognised to differ in depth and duration, and there are time lags between trends in underlying economic drivers (e.g., economic growth and employment) and their impact on tax revenue.

The fiscal *measures* favoured by New South Wales are therefore net borrowing as the flow measure and both net debt and net financial liabilities as stock measures. The net operating surplus does not feature directly in the State's fiscal targets.

12.2.3 Victoria

Currently, the Victorian Government's medium-term fiscal *targets* are as follows:

- maintenance of a substantial net operating surplus; and
- (in the State's non-financial sector as a whole (hereafter "State sector")) maintenance of net financial liabilities at prudent levels.

In support, the Government's short-term fiscal targets are as follows:

- a net operating surplus of at least $100 million in each year; and
- maintenance of a triple-A credit rating.

The fiscal *measures* of the Government's annual financial performance and position currently preferred in Victoria are therefore the net operating surplus as the flow measure and net financial liabilities and, to a lesser extent, net debt as stock measures. Net borrowing does not feature in the State's fiscal targets.

12.2.4 Queensland

The Government's fiscal strategy is outlined in its Charter *of Social and Fiscal Responsibility*. This strategy has been framed to meet a number of objectives, with the overriding requirement to maintain the integrity of the State's finances. The fiscal strategy requires that services provided by the Government be funded from tax and other revenue sources over the medium term.

The fiscal *targets* of the Queensland Government are:

- to ensure that State taxes and charges remain competitive with the other States and Territories;
- to maintain a net operating surplus;
- to only undertake borrowing or other financial arrangements for capital investments and if they can be serviced within the net operating surplus, consistent with maintaining a triple A credit rating;
- to increase net financial assets; and
- (in the State sector) to increase net worth.

The fiscal *measures* favoured by Queensland are the net operating surplus as the flow measure and net financial liabilities and (at the State sector level) net worth as stock measures. Net borrowing does not feature in the State's fiscal targets.

12.2.5 Western Australia

The Government's fiscal *targets* are to:

- maintain tax competitiveness;
- achieve net operating surpluses;
- retain the State's triple-A credit rating; and
- (in the State sector) maintain or increase net worth.

As retention of the triple-A credit rating is not a measurable fiscal aggregate and, in any case, is not directly under the control of the Government, this fiscal target is re-expressed in terms of the following two specific targets:

- (in the State sector) net debt to total revenue at or below 47%; and
- real per capita expenses not to increase.

The fiscal *measures* used by Western Australia are therefore the net operating surplus as the flow measure and (in the State sector) net worth and net debt as stock measures. Net borrowing does not feature in the State's fiscal targets.

12.2.6 South Australia

The Government's fiscal strategy is to contain the public sector's level of liabilities, so as to ensure risks to State finances are prudently managed while maintaining at least a double-A-plus credit rating.

The fiscal *targets* of the South Australian Government are:

- to achieve, on average, zero net borrowing in the general government sector in order that there be no growth in the sector's net debt from operating or investing expenditure;
- to fully fund accruing superannuation liabilities as they arise and progressively fund past service superannuation liabilities; and
- to require all PNFC borrowing to be fully funded from resultant cash flows (effectively zero net borrowing over the life of an asset).

Associated with this, the Government has accepted the discipline going forward of a fiscal transparency framework akin to those in the Commonwealth and Western Australia.

The fiscal *measures* favoured by South Australia are net borrowing as the flow measure (although the cash surplus is to be used for the remainder of the Government's current term) and both net debt and net financial liabilities as stock measures. The net operating surplus does not feature in the State's fiscal targets.

12.2.7 Tasmania

The Government's fiscal strategy is to strengthen the State's financial position by reducing the debt and liability burden on the Tasmanian community.

The fiscal *targets* of the Tasmanian Government are:

- to achieve a cash surplus in the general government sector on a long-term sustainable basis to achieve the Government's net debt targets;
- to use proceeds from major asset sales to retire State debt;
- by June 2008, to eliminate general government net debt and to see total State sector net debt below $1 billion level;
- by June 2017, to eliminate the general government net financial liabilities position;

- by June 2018, to eliminate the State's unfunded superannuation liabilities; and
- to ensure that State taxes remain below the average of all States and Territories and below those of Victoria, and that there are no new taxes and no increase in the rate of any existing taxes.

The fiscal *measures* favoured by Tasmania are the cash surplus/deficit as the flow measure and both net debt and net financial liabilities as stock measures. The net operating surplus does not feature in the State's fiscal targets.

12.2.8 ACT

The fiscal *targets* of the ACT Government are:

- to maintain a net operating surplus over the economic cycle;
- to make adequate provision for long-term liabilities;
- to maintain a low level of debt; and
- to retain a high international credit rating.

The fiscal *measures* favoured by the ACT are the net operating surplus as the flow measure and both net debt and net worth as stock measures. Net borrowing (and net financial liabilities) do not feature in the ACT's fiscal targets.

12.2.9 Northern Territory

The Government has committed itself to a fiscal strategy based on three principles:

- government service levels that are sustainable in a financial sense and which contribute towards the stabilisation of – and ultimately a reduction in the level of – the Territory's net debt;
- a competitive tax environment; and
- prudent management of liabilities.

Each principle contains targets that are the basis on which fiscal decisions are taken.

The fiscal *targets* of the NT Government are:

- by 2004-05, to achieve an 'underlying' cash surplus in the general government sector;
- within 10 years, to achieve a general government net operating surplus;
- to ensure that the Territory's taxes and charges remain competitive with the average of all States and Territories; and
- to reduce the State sector's net debt and employee liabilities (as a % of total revenues) to more State-like levels.

The fiscal *measures* favoured by the NT are the cash surplus (in the short term) and the net operating surplus over the longer term as the flow measures and both net debt and net financial liabilities as stock measures (at the State sector level). Net borrowing does not feature in the NT's fiscal targets on the grounds that it will necessarily vary in accordance with the capital needs of a growing economy.

12.3 THE MEDIUM-TERM POLICY MANAGEMENT CONTEXT

12.3.1 Objectives of medium-term policy management

Medium-term policy management principally involves monitoring the consistency of short-term financial performance (and prospects) with a government's fiscal objectives and principles in the longer term.

The choice of medium-term fiscal targets is therefore influenced importantly by the objectives of medium-term policy management, and the relative weighting given (implicitly or explicitly) to the various objectives.

For the purposes of this chapter, three main objectives of medium-term policy management can be distinguished, namely:

- ensuring maintenance of a government's high priority expenditure programs, both operating and capital (hereafter "policy sustainability");
- promoting a fair sharing in the distribution of public resources and the attendant taxation between current and future generations of taxpayers (hereafter "intergenerational equity"); and
- ensuring a reasonable degree of stability and predictability in the overall tax burden (hereafter "tax stability").

As the selection and definition of medium-term fiscal targets must be judged by how well the targets aid achievement of these medium-term policy management objectives, the following section explores more closely the nature and implications of each of these medium-term policy management objectives.

12.3.2 Scope of fiscal sustainability

In this report, the term 'fiscal sustainability' refers to the situation where a government's present and probable future policy settings do not jeopardise any of the government's medium-term policy management objectives – the achievement of intergenerational equity and tax stability objectives as well as a sustainable balance sheet position.

12.3.2.1 Policy sustainability

A government's expenditure priorities (both operating and capital) can be put under pressure if its present and probable future policy settings give rise to an 'unsustainable' balance sheet position.

It is the set of 'present and probable future policy settings', rather than occurrences in any single year or series of years, which is relevant to policy sustainability.

The sustainability of a government's present and probable future settings in this sense is best captured by the following question: given spending and taxation anticipated on a no-policy-change basis over the longer-term, is the government likely to be required to alter its discretionary spending policies (or its taxation policies) over time to prevent the emergence of an unsustainable *balance sheet position*?

In the sense that the term is used here, sustainability analysis focuses on whether a government's policy management could be continued indefinitely under unchanged policies, given anticipated developments. Improving the ability within government to anticipate developments and cushioning against adverse economic and financial shocks are both important. The aim is to avoid the need for disruptive expenditure cuts or tax increases.

Policy sustainability is an important issue not merely because current policies, if unsustainable, must later be changed, but because unsustainability becomes a more and more important problem as time goes on and as budget deficits increase due to the accumulation of liabilities.

In this sense, there are clear interactions between the fiscal (or aggregate) objectives and the budgetary objectives of policy at the sectoral and program level. The causality can run both ways. Weaknesses in the design and operation of spending and tax programs could contribute directly to

unsustainable fiscal outcomes. At the same time, if unsustainable fiscal outcomes are in prospect, then it is likely that some of a government's budgetary/sectoral objectives will go unmet as a consequence.

12.3.2.2 Intergenerational equity

Intergenerational equity (or fairness) can be defined in various ways. Those in the literature include:

- equality in the effective lifetime tax rates of current and future generations;
- equality in the lifetime consumption of public goods and services by current and future generations; and
- more generally, equality in the unit tax price of public goods and services borne by current and future generations.

This latter definition of intergenerational equity seems most practical from a policy point of view. This definition sees the costs associated with expenditure being spread over time in accordance with the distribution over time of the benefits that are generated. Hence, the starting point is the 'benefit principle' of equity, according to which an equitable tax system is one under which the taxes paid by each individual should be in proportion to the benefits they receive from government spending.

The intent is to avoid policies that lead to the ongoing accumulation of debt and other liabilities, without funding socially useful productive investments, which thereby transfers the cost of paying for the lifestyle of the current generation to future generations.

That said, the intergenerational equity of a particular element of government spending and financing cannot be considered in isolation. For example, an investment project that appears to be intergenerationally unfair in isolation may enhance intergenerational equity overall because it compensates for intergenerational unfairness elsewhere.

Implementing intergenerational equity poses certain practical problems. First, the time profile of future benefits of government spending is subject to great uncertainty. This makes it extremely difficult as a practical matter to synchronise the amortisation of the debt (and tax payments on future generations) with the time profile of benefits from government investment. Secondly, there may be inconsistencies between the GFS definition of current and capital spending and the duration of economic benefits resulting from government expenditure. To ensure intergenerational equity, all government spending which results in benefits extending beyond the 'current' period should be allocated to future generations and taxed accordingly. But this could include certain expenditures classified as current – such as certain types of education or health expenditure – which may provide benefits beyond the current period.

The interpretation of intergenerational equity used here implies that taxes are akin to prices. Only when taxes are set to recover all operating costs are taxes 'equitable' both between different current taxpayers and between current and future generations of consumers.

12.3.2.3 Tax stability

It is generally acknowledged that all taxes (except, perhaps, lump-sum taxes) are distorting (in that they can influence economic behaviour with resultant diminution of allocative efficiencies). For this reason, the timing of taxes can matter, and it is desirable to smooth tax rates over time to the greatest extent possible.

It is therefore not advisable for a government to unduly alter tax rates contemporaneously with temporary fluctuations in expenditures. Given that the marginal deadweight cost of taxation rises with the tax rate, the total cost of revenue-raising will be minimised if the planned tax rate is fairly constant (smoothed) over time. A smooth tax rate implies that temporary shocks to government spending give rise to budget imbalances, and provides a rationale for the issuance of public debt.

The concept of tax smoothing is well established in the literature on fiscal policy. A government anticipating an increase in its own expenditure can minimise the distortionary effects of raising the finance for that expenditure if it brings forward some of the associated tax increase and runs a budget

surplus (or a smaller deficit) in the current period. Similarly, a budget deficit (or a smaller surplus) is desirable if a government anticipates future falls in its expenditure.

In the presence of predictable changes in its future expenditure (and in the absence of a politically acceptable 'first-best' system of lump-sum taxes), a government is advised to undertake the required tax smoothing through its borrowing and lending behaviour. Welfare losses will be minimised if, in responding to new (unforeseen) information about the path of future government expenditure, the government smooths the implied change in tax rates over time.

12.4 PRACTICAL IMPLICATIONS OF EACH OBJECTIVE

12.4.1 Assignment of measures to objectives

Given the nature of the objectives of medium-term policy management, the choice among the different measures of a government's annual financial performance and position can be narrowed down as follows:

- *Policy sustainability* is promoted where a government's financial position remains above a targeted minimum (or floor) position. Taxation revenues, capital expenditures and discretionary tax-funded expenses (net) are the policy variables assigned to achievement of the policy sustainability objective.

- *Intergenerational equity* is promoted where the net operating surplus converges on zero (i.e., a net operating balance). Tax revenues and discretionary tax-funded expenses are the policy variables assigned to achievement of the intergenerational equity objective.

- *Tax stability* requires tax revenues (more correctly, tax rates, although actual tax bases in Australia still need substantial improvement) to change little over time. Capital expenditures, discretionary tax-funded expenses (net) and the level of net borrowing/lending are the policy variables assigned to achievement of the tax stability objective.

12.4.2 Trade-offs between medium-term policy management objectives

The above consideration of the nature of the different objectives also suggests scope for certain trade-offs between the objectives.

First, there may be a trade-off between intergenerational equity and tax stability. If a net operating balance is maintained for intergenerational equity purposes, then taxation revenues will rise and fall with tax-funded expenses, thereby breaching the tax stability objective.

For similar reasons, a potential trade-off exists between policy sustainability and tax stability. If policy sustainability is to be achieved, taxation revenues (and tax rates) are required to rise and fall to offset rises and falls in tax-funded expenses and the acquisition of non-financial assets, jeopardising the tax stability objective.

Finally, there may also be a trade-off between policy sustainability and intergenerational equity. If net financial liabilities (or net debt) is the target stock measure, policy sustainability requires focus on net borrowing (or the cash deficit/surplus). The associated size of the net operating surplus is of little interest *per se*. The pursuit of a sustainable position might justify a larger net operating surplus than warranted on intergenerational equity grounds, or a net operating deficit might be possible in other circumstances. Only if net worth is the policy sustainability target might it be possible *in principle* to simultaneously pursue the intergenerational equity and policy sustainability objectives, given the direct relationship between the net operating surplus and net worth. Measuring net worth for general government sectors itself is a difficult practical issue: for example governments' taxing powers are not necessarily fully recognised under current accounting standards (see below).

12.5 ALTERNATIVE APPROACHES TO SETTING TARGETS

Once a fiscal measure concept has been chosen as the basis for a target, a further task for medium-term policy management is choosing the approach to setting the targeted quantitative value for that measure.

12.5.1 'Internal' versus 'external' targets

In essence, there are two different approaches to target setting:

- 'internally-derived' targets, where the target is set in terms defined by – and relevant to – a government itself; and
- 'externally-derived' targets, where the target is largely set by exogenously considerations, and so not capable of being varied by a government.

Internally-derived targets are 'soft' targets in the sense that it is within a government's power to vary the specification of these targets when it so chooses. In this sense, in contrast, externally-derived targets are 'hard' targets.

Medium-term policy management is most likely to be effective where the targeted value of measures of a government's annual financial performance or position are either externally-derived (hard) ones, or internal targets that are derived (perhaps with a safety margin) from possible externally-derived targets.

12.5.2 'Floor/ceiling' versus 'policy' targets

For medium-term policy management purposes, it is also necessary to distinguish between two different types of targets, namely:

- 'floor/ceiling targets', where the target set is the chosen fiscal measure's value that a government seeks at all times *to avoid* exceeding or breaching; and
- 'policy targets', where the target set is the value of a nominated fiscal measure that a government seeks *to achieve* in the short to medium term, with departures away from the target only tolerated for short periods.

Sometimes, but not always, floor/ceiling targets are externally-derived, and policy targets are internally-derived.

Medium-term policy management essentially involves two distinct tasks:

- comparing the effects of alternative policy settings on a government's financial performance and position in coming decades; and
- monitoring the consistency of short-term fiscal outcomes at any point in time with the government's fiscal objectives and principles in the medium term.

Medium-term targets are usually in the nature of floor/ceiling targets, placing limits or constraints on the expected value of target variables over the medium term. By their nature, policy targets guide policies in the short term and ensure that current policy settings not only avoid exacerbating medium-term difficulties but also contribute in accommodating such difficulties over time.

A comparison of alternative policy settings is likely to require floor/ceiling targets, whereas evaluating the consistency of short-term and longer-term policies is likely to require policy targets. To inform contemporary policy decisions, policy targets are more likely to be based on flow (rather than stock) measures.

12.6 POLICY SUSTAINABILITY TARGETS

12.6.1 On policy sustainability

Policy sustainability focuses on whether, given anticipated developments, a government's present and probable future *policy settings* can continue unchanged indefinitely. At issue is whether a government is likely to be forced over time to alter its spending and taxation policy settings.

12.6.1.1 Policy sustainability as a balance sheet issue

Policy sustainability ultimately is a *balance sheet* issue. Like any large vertically and horizontally integrated corporate entity, the only hard constraint on a government is its balance sheet position. Solvency is always a balance sheet matter. Governments, like corporations, can register annual net operating deficits for long periods while nevertheless remaining solvent because of the net assets held on their balance sheets or the cash flow-earning potential of those assets.

That said, unlike large corporates, a government consists of instrumentalities which are:

- engaged in exercising a monopoly of compulsory powers within a territorial area or its parts;
- engaged primarily in the provision of non-market services and infrastructure (whether supplying public goods or administering direct financial transfers) and mainly for collective consumption of the community;
- financed mainly through the collection of taxes and other compulsory levies on households, financial institutions and corporate enterprises – with taxes capable of being imposed without any reciprocal obligation on the government concerned; and
- 'sovereign' in the sense that, in contrast to private parties whose undertakings are enforceable in law, a government has much greater scope to renege on its undertakings if it so chooses given its ability to rewrite laws and opt not to be bound by an earlier government with different aims and objectives.

For these reasons, a government's measured balance sheet may be less useful in indicating policy sustainability than typically the case for a large corporate. The main 'asset' missing from a government's measured balance sheet is the power to raise taxes. The main 'liability' missing is the value of a government's future benefit and transfer payment commitments. In fact, in some jurisdictions, the implicit assets and liabilities of the public sector represented by the streams of future tax revenues and of future benefits and transfer payments could dwarf the measured financial assets and liabilities in a government's balance sheet.

However, none of this justifies the use of flow targets *per se* as policy sustainability targets. The power to tax is not infinite, given the impact of taxes on economic prospects and incentives. Moreover, the power to tax has not prevented the government debt defaults that have occurred in history, including defaults at the international level over the last decade. The most that can be said is that consideration has to be given to augmenting or carefully interpreting targets based on *measured* balance sheets concepts.

12.6.1.2 Role of flow targets for policy sustainability purposes

Some governments appear to focus on the net operating surplus *flow* measure for 'policy' sustainability reasons.

For example, the Commonwealth has argued that:

> *"By including all accruing costs, including depreciation, the net operating balance encompasses the full costs of providing government services. This makes it a good measure of the sustainability of the government's fiscal position over time and provides an indication of the sustainability of the existing level of government services."*

While the net operating surplus measure has many merits, at best it is only a partial indicator for *policy* sustainability purposes. The achievement of a net operating surplus only indicates two things:

- first, that borrowing is not being used to finance the current year's operating expenses; and
- secondly, that any borrowing that has occurred in the past will be serviced in the current year (by ensuring taxation revenue in the current period recovers both interest expenses on past borrowings and, by expensing depreciation, a proportionate return 'of' the capital invested in the past in non-financial assets used in the current period to provide services to taxpayers).

While these may be necessary conditions for policy sustainability, they will not be sufficient by themselves.

The existence of a net operating surplus implies nothing about the appropriateness of the current year's borrowing program or the capital uses to which such borrowing is being put. First, the volume of borrowing might result, in time, in concerns by lenders about excessive gearing of a government's balance sheet. This involves lender's holding notions as to (in)appropriate government capital structures, which put limits (capital budget constraints) on borrowing and/or considerably increases the cost of any excess borrowing or borrowing while debt is high.

In addition, there is the possibility that new acquisitions of non-financial assets financed with the proceeds of borrowing may not give rise over time to benefits on the scale expected at the time of the original investment. This would result in a write-down in the value of assets, which may see a shortfall emerge over time in the value of assets relative to the total borrowings being serviced by the government.

A net operating deficit is therefore not the only source of policy unsustainability. To be comprehensive, the fiscal targets chosen must discipline capital as well as operating spending. Once a stock measure is chosen, use of an *overall* budget surplus target would impose greater discipline in this regard than merely a net operating surplus target.

Policy sustainability therefore involves targeting (and monitoring) both operating and capital spending, with lenders imposing constraints on the capital spending side even if the planned purchases of new non-financial assets are assessed by proponents as involving positive net present values. Just as a capital budget constraint is faced by corporates, capital markets impose similar constraints on government investment in fixed assets and infrastructure to the extent that external financing is involved.

Such externally-imposed capital constraints are avoided only where capital spending can be financed entirely from internal sources. In these circumstances, focus on a flow measure might be appropriate. The relevant flow measure would nevertheless encompass both operating and capital spending. Such a flow focus would only be justified while net borrowing was not necessary. Such financially-conservative circumstances would be difficult to justify over the medium term on policy sustainability ground alone, as it would imply the emergence of a net creditor position. A government as a net creditor is difficult to justify.

12.6.2 Choice of relevant financial position measure

Having opted for the use of stock measures as a basis for defining *policy* sustainability targets, the next question is: which stock measure is most appropriate for this purpose? The choice is between net worth, net financial liabilities and net debt.

For reasons discussed below, this choice usually depends upon whether internally-derived or externally-derived targets are under consideration, and the related issue of whether medium-term floor/ceiling targets or short-term policy targets are involved. Net debt is typically used as a basis for establishing floor/ceiling targets, whereas net financial liabilities seem the most appropriate measure for internally-derived targets.

12.6.2.1 Net debt versus net financial liabilities – narrow versus broad debt

Capital markets (especially the international credit rating agencies) continue to give preference to net debt rather than net financial liabilities as the primary measure of a government's financial position. Table 12-3 shows the derivation of net financial liabilities from net debt.

Table 12-3: Relationship between net debt and net financial liabilities

Net debt
plus Superannuation liabilities + Other employee entitlements and provisions (together termed hereafter as "debt-like liabilities")
plus Other non-equity liabilities – Other non-equity assets
less Equity investments
equals Net financial liabilities

It is apparent that net debt and net financial liabilities differ mainly because the latter includes both:

- unfunded employee entitlements (including unfunded superannuation benefits) as measured by the present value of the difference between the projected primary expenditure and revenue (at current contribution rates) on such entitlements; and
- equity invested in government-owned corporations as an offset against the relevant liabilities.

Capital markets prefer net debt over net financial liabilities as the primary measure of a government's financial position in that they consider – with good reason – that 'narrow' debt ranks above the other components of 'broad' debt when it comes to the payment of interest and the repayment of principal.

In addition, capital markets do not consider a government's equity investments as being sufficiently liquid to be offset against financial liabilities when assessing the capacity to ensure the timeliness of debt servicing. A government's preparedness to sell its equity investments is subject to much more complex (and unpredictable) considerations than is the case with regard the government's holdings of marketable financial assets. Capital markets typically have regard to those financial assets that a government holds for liquidity management purposes (cash and deposits, advances held and loans, placements and investments). Investments held for policy purposes – which include both the equity capital and the debt capital (advances paid) employed in government-owned corporations – are typically not considered to be suitable offsets against debt and debt-like liabilities.

When it comes to setting internally-derived targets, however, a government would be prudent to be seen to be giving due weight to its shareholder/investment responsibilities. This is an important (and sometimes neglected) function of the general government sector.

Also, governments are justified in not placing too great a weight on the fact that no enforceable promises may have been made by government as to the future levels of benefits and contributions (the first could always be lowered and the latter be raised). The same type of reasoning applied to narrow debt would imply that debt was also irrelevant and non-existent, as debt could be redeemed by raising taxes or spending cuts or, in the extreme, might not be repaid at all. While the obligations associated with unfunded superannuation liabilities are often based on political commitments (which are subject to democratic voting and hence, in principle, are more easily altered than the obligations associated with narrow debt which are based on property rights), it is best that a government pursues medium-term policy management on the basis that it prefers not to distinguish between debt and debt-like liabilities.

Also, while unfunded superannuation liabilities do not bear interest in the sense that narrow debt does, the opportunity cost of the unfunded liabilities is accounted for in accrual GFS statistics through the 'nominal superannuation interest expense' item.

Finally, governments are intent on increasing the funding of their superannuation schemes. If a government decides to transfer its employee superannuation scheme to a private insurer, without changing the rules of the system, the private provider would make an actuarial estimate of the

contingent liability and establish a trust fund to offset this liability. The government would have to fund the amount deposited in the trust fund (either by borrowing or by drawing down its holdings of financial assets), with the proceeds being handed over to the private funds manager. Hence, future funding of superannuation schemes would convert the contingent liability into an increase in net debt.

To sum up, for internally-derived financial targets, a government is justified in choosing the net financial liabilities measure of its financial position for medium-term policy management purposes in preference to the net debt measure.

That said, if a government targets fully funding of its debt-like liabilities in time, and if the mismatch between other non-equity assets and liabilities is largely a reflection of timing considerations, then the underlying targeted level of net financial liabilities is the targeted level of net debt less the targeted level of equity invested in government-owned corporations. A government's equity investments in its public corporations is a policy decision based upon a mix of considerations, and largely independent of budgetary policy considerations. Hence, once a particular level of net debt is targeted, the associated (targeted) net financial liabilities may be largely determined, and vice versa.

Alternatively, consideration may be given to using a 'broad' debt notion that does not include equity invested in government-owned corporations in any offsetting financial assets. Over time, this would merge on a targeting of net debt.

12.6.2.2 Net financial liabilities versus net worth

Some jurisdictions treat net worth as a superior measure of a government's financial position than net financial liabilities (or net debt).

However, the net worth measure involves some interpretative difficulties. While net worth is a balance sheet concept that can quite clearly be measured for companies and households, the task is not so easy for a government. First, government assets that do not yield any stream of income or are part of social infrastructure that yields significant positive externalities are difficult to value. Secondly, as noted above, a government's power to tax is an important non-measured asset and obligations to make transfer payments represent non-measured liabilities for some governments.

These measurement issues aside, as Table 12-4 shows, net worth is linked closely to the net financial liabilities measure.

Table 12-4: Relationship between net worth and net financial liabilities

Non-financial assets
less Net worth
equals Net financial liabilities

Therefore, by definition, the targeted value of net worth is the difference between the targeted level of non-financial assets and the targeted value of net financial liabilities. As the targeted level of non-financial assets is a budgetary rather than a fiscal consideration, targeting net financial liabilities may be more prudent from a medium-term *fiscal* perspective than targeting net worth *per se*.

12.6.3 Setting sustainability targets

Once the key measure of a government's financial position has been nominated, the next step in specifying a fiscal indicator is to nominate a target quantitative *value* for that measure. As noted earlier, a government may wish to establish a (medium-term) externally-derived *floor/ceiling* target, and a (short-term) internally-derived *policy* target.

12.6.3.1 Medium-term ceiling target

A ceiling target for policy sustainability purposes represents the value of the key measure of a government's financial position (expressed in net liability-like terms) *above which* the government

would not wish to go, and so might warrant adjustments to present or probable future policy settings involving an *increase* in taxation and/or a *reduction* in spending.

Loss of double-A-range credit rating

For policy sustainability purposes, the most usual ceiling targets relate to the externally-derived maximum level of net debt which, if breached on a no-policy-change basis, would unambiguously force a policy adjustment.

The highest ceiling that an Australian State might contemplate is the net-debt-to-GSP ratio that would trigger a downgrading of the credit rating on a government's long-term local currency-denominated debt issues below the double-A range. Were a State's credit rating to fall below the double-A range, this would see not only a sizeable increase in borrowing costs but also, because it would be an unprecedented development, the likelihood of Commonwealth Government intervention (through Loan Council-type arrangements) including to forestall any impact otherwise on the sovereign (national) rating.

If preferred, the externally-derived net debt ceiling associated with preservation of a double-A-range rating could be expressed in terms of the associated net financial liabilities-to-GSP ratios.

Avoidance of negative net financial liabilities

A net financial liabilities ceiling could be derived independently of externally-derived net debt ceiling targets.

Loss of net financial worth (i.e., movement into a positive net financial liabilities range) is the most obvious possibility. But the net worth concept, as noted above, is a difficult concept to define for the public sector.

12.6.3.2 Medium-term floor target

A floor target for policy sustainability purposes represents the value of a measure of a government's financial position (expressed in net liabilities-like terms) *below which* the government would not wish to go, and so might warrant adjustments to present or probable future policy settings involving a *reduction* in taxation and/or an *increase* in spending.

Zero net debt would seem to be an appropriate floor target for a government's financial position. It is difficult to justify a government adopting a net creditor position. In such circumstances, taxpayers funds would be being applied to investing in marketable financial assets. The opportunity cost of such a strategy must be high, and may attract risks associated with any interest arbitraging involved.

12.6.4 Short-term policy target

Rather than medium-term floor and ceiling targets, a short-term policy target may be preferred as a guide to policy determination to ensure medium-term constraints are not breached in time or any prospective problems are not exacerbated.

12.6.4.1 Stock target

Theoretical analysis provides little guidance as to a government's optimal capital structure (net debt-to-total assets ratio). More practical bases are required.

Floor/ceiling midpoint

The midpoint between medium-term floor and ceiling targets is an obvious short-term policy target.

Stable net financial liabilities-to-GSP ratio

Most fiscal targets in policy literature (implicitly or explicitly) suppose that medium-term policy management targets the *stabilising* of a government's liabilities-to-GSP ratio.

While *stabilising* a government's net financial liabilities-to-GSP ratio does not return its annual financial performance or position to any sort of a target level, such a target is easily understood and widely used.

Maintaining a State's current credit rating

A net debt policy target could be set consistent with avoiding the loss of a State's current long-term local currency-denominated debt issues. Were the State's credit rating to be downgraded, this would involve an external vote – by and on behalf of the investor community – of 'diminished' confidence in the government's fiscal policy and prospects. In addition, a slight increase in borrowing costs is likely and, more importantly in the longer-run, the government would be subject to an increased exposure to blowouts in borrowing cost margins whenever capital markets periodically become more risk averse.

12.6.4.2 Short-term flow target

Once a targeted stock ratio (expressed in either nominal or real terms or as a ratio of GSP) is nominated for short-term policy target purposes, the associated sustainable flow ratio can be solved for using the stock-flow identities. This provides the basis for an *indirect* indicator of policy sustainability.

Indirect flow targets have the advantage that they may be operationally more useful. While a medium-term stock ratio can be interpreted as a broad gauge of fiscal rectitude, short-term targets expressed in balance sheet terms (such as net debt or net financial liabilities) are less operationally meaningful than limits on annual financial flows (notably net borrowing). Stocks are only influenced by a government through the government's policy influence on annual financial transactions (flows).

Floor/ceiling midpoint

Targeting a net borrowing level that would result over time in the achievement of the midpoint between medium-term floor and ceiling stock targets is an obvious starting point.

Zero net borrowing

Targeting zero annual net borrowing implies the maintenance of net financial liabilities at current real-terms levels (after any revaluation effects are also taken into account).

The maintenance of net financial liabilities at current levels translates into a declining medium-term path for the net financial liabilities-to-GSP ratio, given the real-terms growth rate expected for the economy. While such a reduction in the net financial liabilities ratio may be warranted, there is no clear basis on which to judge by how much and how rapidly the ratio should fall.

Gradually reducing the net financial liabilities ratio may provide some room for future fiscal manoeuvre while not placing unrealistic – and hence perhaps self-defeating – pressures on a government. Much depends upon the targeted 'internal financing ratio', that is the internal sources of capital financing as a percentage of the (gross) acquisition of non-financial assets.

Pursuing zero net borrowing would imply a 100% internal financing ratio, and so a net operating surplus large enough to finance the net acquisition of non-financial assets undertaken in a given year. If the internal financing ratio is greater than 100%, negative net borrowing is targeted. If the internal financing ratio is less than 100%, net borrowing is targeted.

A 100% internal financing ratio may be justified when a government's existing net financial liabilities (or net financial liabilities-to-GSP ratio) are deemed high. Likewise, a 100% internal financing ratio may have been justified in the past where there was no assurance that:

- borrowing was not being used to finance operating expenses; and
- any borrowing which does occur now will be serviced in future by ensuring taxation revenue in any particular future period recovers both interest expenses on the debt and depreciation expenses.

Provided a government adopts a net operating surplus policy target in conjunction with any net borrowing/lending target, targeting zero net borrowing may be an unnecessarily high hurdle test for the government to adopt in the medium term. Only if the government faces borrowing constraints (hence the need to examine the balance sheet position for policy sustainability purposes), may it have to fully finance now the capital works program intended to underpin future provision of public goods and services.

Maintaining current level of net financial worth

Maintaining the current net financial worth-to-GSP ratio is another possible target. In most States, however, this would imply an internal financing ratio in excess of 100%.

Maintaining a State's current credit rating

An internal financing ratio could be targeted that is consistent with the net debt-to-total assets ratio identified as necessary to maintain the current credit rating.

Provided 'value for money' criteria are applied to capital spending, a government may borrow now to help finance the provision of infrastructure, with a view to servicing the costs of such borrowing in the future. This requires public investment appraisal involving estimates of the net present value of the social benefits and costs of investment proposals (including the deadweight costs associated with any distortionary taxes that may have to be levied in the future if the cash returns on the investment are insufficient to cover the costs).

That said, it is also widely accepted that such rules are best suited to the ranking of projects and say little about the appropriate cut-off point for new investment. As in the private sector, capital budget constraints will always mean that not all projects with apparent positive net present values can proceed. As argued above, the extent of borrowing will be ultimately influenced by external capital market notions about a government's present and probable balance sheet position relative to notions of maximum gearing levels.

Limitations on flow-based targets for policy sustainability purposes

While flow-based targets have their practical attractions, they can only serve as *indirect* targets of medium-term policy sustainability. If a flow target is significantly exceeded for a period of time (e.g., due to over-forecasting of expenditure), the target may need to be adjusted so that it would be consistent with the achievement of the (unchanged) underlying stock-based target.

12.7 INTERGENERATIONAL EQUITY TARGETS

12.7.1 Defining intergenerational equity

Intergenerational equity is defined as ensuring the equality of the unit tax price of public goods and services borne by current and future generations. This is based on the 'benefit principle' of equity, according to which an equitable tax system is one under which the taxes paid by individuals should be in proportion to the benefits they receive from government spending.

12.7.1.1 Benefit principle versus 'lifetime' basis

The straight-forward use of the benefit principle might be questioned on the basis that there is an implicit intergenerational contract whereby the younger generation of taxpayers pay for the health care and pensions of the older generation after the latter have ceased being taxpayers. The expectation is that future generations will carry on the same favour once the current generation too get old and cease paying taxes. This is tantamount to a notion of intergenerational equity based on the notion of an equality of lifetime consumption of public goods and services. This latter view implies that, in an ageing population context, where there are reasons to believe the future (smaller) generation will be unable to incur more than their 'fair' share of the current (larger) generation's health care and pension costs, the current generation should set aside funds (or higher operating surpluses) now to pay for some of their future health and pension costs later.

This argument has particular merit at the Commonwealth level, where Commonwealth taxpayers are primarily responsible for funding most pensions and many health care costs. State governments too are affected by rising health care costs. However, this argument can be accommodated by early recognition of the emerging (future) liabilities involved. By recognising the associated operating expenses, a balanced net operating position could be targeted *inclusive* of such expenses.

12.7.1.2 Benefit principle versus 'capacity to pay' basis

The current tax system could also be said to reflect a view that it is equitable for those on higher incomes (greater capacity to pay) to incur higher tax rates (progressivity of tax rates). A corollary might be that, as future generations will be earning much higher incomes (assuming reasonable productivity growth), they should pay higher rates of tax. In this way, net operating deficits today could be paid for by future generations without any loss of intergenerational equity.

If intergenerational equity was based on the ability to pay principle rather than the benefit principle, and if (for example) per capita incomes were expected to rise over time, it may be appropriate for the present generation to impose a burden on future generations. However, the capacity to pay argument is not specifically designed for inter-temporal comparisons. It works best when high and low income taxpayers have the opportunity for a contemporaneous say in determining both the level of public goods and services to be produced and the relative burden of financing. In an intergenerational context, the future generation has no say in the level of current services. As there would be nothing to determine whether the intergenerational allocation of taxes was in fact equitable, the use of the benefit principle seems appropriate as there is little justification otherwise for the current generation to shift financing onto future generations.

12.7.2 Choice of relevant financial performance measure

Indicators of the extent to which the intergenerational equity objective of medium-term policy management is being achieved involve flow targets.

Specifically, a measure of a government's annual financial performance is required that indicates the extent to which today's taxpayers pay for today's current spending while public investment, which will benefit future generations, is paid for by future taxpayers. Current spending (operating expenses) involves spending on outputs the consumption of which give rise to benefits derived wholly in the current period. Capital spending results in benefits beyond the current period. Intergenerational equity requires future generations to pay for public investment, in line with the benefits they receive from that investment.

Only the net operating surplus measure of a government's annual financial performance distinguishes between current and capital expenditures, and between the financing of the former through taxation (the 'tax price' paid by current taxpayers) and the latter through debt (to be serviced by tax prices paid by future taxpayers). Both accrual and cash net borrowing measures fail to make the necessary distinction between current and capital spending (and financing).

12.7.3 Setting intergenerational equity targets

12.7.3.1 Medium-term floor target

A floor target for intergenerational purposes represents the net operating surplus level *below* which the government would not wish to go, and so might warrant adjustments to present or probable future policy settings involving an *increase* of taxation and/or a *reduction* in operating expenses.

A relatively strict interpretation of the intergenerational equity objective would require the net operating balance to not go below zero each year. However, net operating deficits in a particular year could be consistent with intergenerational equity provided that they were only cyclical in nature and offset by subsequent surpluses.

Other considerations suggest the need, for intergenerational equity purposes, for the targeting of a net *operating* deficit measured on a standard GFS basis. Some investment may be classified under ABS/GFS accounting conventions as expenses, particularly in the education and health areas where preventative expenditure may benefit future generations of taxpayers and education spending may increase the human capital of future generations of taxpayers. Offsetting this to an extent may be the

treatment of some spending largely benefiting current taxpayers as 'investment'. On balance, these considerations alone could justify targeting a slight net operating *deficit*. However, there is uncertainty about these future benefits, and a prudent approach would be to give them little weight for the time being.

Incorporating revaluations as allowed under AAS31 could also justify targeting a slight net operating deficit on a transactions basis only. However, while price movements affecting non-financial assets might result in more predictable revaluations (while general price inflation is positive) than those affecting financial assets (interest rates and exchange rates), a government would be well advised not to consume these amounts as it would involve eroding the *real-terms* value of the capital employed by the government and so its net worth.

Other considerations suggest the need, for intergenerational equity purposes, for net operating *surpluses* measured on a standard GFS basis. For example, a zero net operating surplus would not involve a return 'on' the capital employed by government. The GFS definition of the net operating surplus does not include, as an expense for tax pricing purposes, the 'return on' capital element of capital costs (only the return 'of' capital element (depreciation)). From an intergenerational equity perspective (and an economic efficiency perspective) therefore there may be grounds either for targeting a net operating surplus equal to a return on capital employed in providing tax-funded goods and services or in incorporating an allowance for the 'return on capital' when calculating the net operating surplus.

In this sense, taxes may not be recovering all costs of producing public goods and services. Only depreciation (i.e., the return of capital) is allowed for in the standard GFS measure of net operating surplus. Some governments include the full cost of capital in individual agency accounts through a capital charging regime, but do not include the associated return on capital amounts in the aggregate government accounts. This has the effect of only requiring user charges – and not necessarily taxes – to fully recover the costs of providing public goods and services.

The main reason why a return 'on' capital employed cost component is not included in taxes, is that this is the only means by which taxpayers effectively receive a dividend on the (equity-like) capital that they effectively have invested in government provision. In effect, the dividend is a 100% of the return on capital component, with the dividend being distributed in proportion to their tax payments.

On balance, while arguments can be put in favour of positive and negative net operating balances, a zero net operating surplus over the business cycle would seem to be an appropriate floor target for intergenerational purposes given current knowledge.

12.7.3.2 Medium-term ceiling target

A ceiling target for intergenerational purposes would involve identifying the net operating surplus value above which the government would not wish to go, and so might warrant adjustments to present or probable future policy settings involving a decrease of taxation and/or an increase in operating expenses.

12.7.3.3 Short-term policy target

A short-term target, to guide policy determination in such a way as to ensure medium-term constraints are not breached or any prospective problems are not exacerbated, would most obviously be midway between the medium-term floor and ceiling targets.

12.8 TAX STABILITY TARGETS

12.8.1 On tax stability

It has been argued that the impact of a government's revenue-raising activities upon economic behaviour could be minimised were the planned tax rates *smoothed* over time. Further, the suggestion is that economic efficiency losses could be minimised if, in responding to new (unforeseen) information about the path of future government expenditure, a government were to smooth the implied change in tax rates over time.

A smooth tax rate implies that temporary shocks to government spending give rise to budget imbalances, and provides a rationale for the issuance of public debt in response to negative shocks even when used for financing operating expenses.

12.8.1.1 Relationship to policy sustainability

On first appearances, tax stability seems to be (only) the opposite side of the 'policy sustainability' coin. Is this correct?

There is a relationship between tax stability and policy sustainability, but only to the extent that tax policy is the primary policy variable assigned to achieving the policy sustainability objective. However, policy sustainability can be achieved through other means, notably via adjustments to spending policies (with the latter covering both operating and capital expenses). Tax-funded expenses (net) can also be reduced by increased resort to user charges where these can be justified.

Policy adjustments aimed at achieving policy sustainability may have no effect upon tax policy (and so tax stability) where the adjustment takes place through non-tax means.

This does not deny that inefficient taxes should be phased out and that more efficient taxes phased in. Ultimately, the concern with tax stability is that taxes should primarily be adjusted in the pursuit of efficiency objectives, not on the basis that taxation revenue is a policy variable assigned to achieving policy sustainability.

12.8.1.2 Relationship to intergenerational equity

Similarly, there is a relationship between tax stability and intergenerational equity, but only to the extent that tax policy is the primary policy variable assigned to achieving the intergenerational equity objective. However, intergenerational policy can be achieved through other means, notably via adjustments to operating expenses and in non-tax income (e.g., changes in user charges).

Policy adjustments aimed at achieving intergenerational equity may have no effect upon tax policy (and so tax stability) where the adjustment takes place through non-tax means.

In addition, tax stability is really about tax *smoothing*. 'Smoothing' does not imply no-change in tax rates. If tax changes are inevitable, the implication is that they should be smoothed through the use of borrowing or other non-tax instruments.

12.8.2 Choice of relevant financial performance measure

Fiscal targets relating to the tax stability objective of medium-term policy management involve flow measures. Specifically, the focus is on a government's annual tax revenues.

In a cash accounting world, both capital and current spending were assigned to achieving the tax stability objective of medium-term policy management. In the more sophisticated accrual world (and one which also stresses intergenerational equity), current spending and non-tax income are the appropriate policy variables for achieving the tax stability objective.

12.8.3 Setting tax stability targets

Tax stability requires tax revenues (more correctly, tax rates) to remain little changed over time where at all possible. The initial target tax rates most likely would be rates currently applying, with economic efficiency considerations suggesting that costs might be imposed were tax rates to change from current levels. However, there may be grounds for adopting target tax rates different to current levels if current taxes were agreed to be economically inefficient and scope existed for tax changes to take place.

12.9 CONCLUSION

Fiscal targets and indicators are needed to assess whether – given the medium-term prospects for the State annual financial performance and position – a government's present and probable policy settings

may need to be adjusted in order to maintain the integrity of the State's finances in face of likely budgetary developments.

The choice of fiscal targets is influenced importantly by the objectives of policy management, and the relative weighting given (implicitly or explicitly) to those various objectives.

Targets based on the net operating surplus by their nature relate mainly to the pursuit of the intergenerational equity objective rather than the policy sustainability objective. [Targeting the net operating surplus for policy sustainability purposes is only warranted where policy sustainability is defined in terms of net worth.]

For policy sustainability purposes, a focus on maintaining a prudent net financial liabilities position is of more use than net operating surplus-based targets. Net borrowing is the annual financial performance measure that most directly determines movements in net financial liabilities. Targeting net borrowing would help to ensure discipline with respect to capital spending as well as on operating expenses. Setting a quantitative net borrowing target is primarily an empirical matter, however, as economic theory provides little practical guidance.

Finally, a tax stability target may play a role in monitoring the extent to which likely economic and demographic pressures on government spending – if unchecked – could put upward pressure on State taxes and/or increase the volatility of tax rates.