Fiscal space in the G-20

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The G-20[2] is a forum that promotes open and constructive discussion between the advanced and major emerging economies on key issues related to global economic stability. The inclusion of fiscal space in the G-20 work program for 2007 and 2008 highlights the importance of this issue for both developed and major emerging market economies.

Fiscal space reflects a government's capacity to finance new spending without harming medium and long-term fiscal sustainability. Although there are some well-established tenets of good fiscal management, there are also a number of contemporary challenges in this area.

Drawing on discussions within this forum, this article highlights the importance of fiscal space for G-20 countries and outlines the contemporary challenges they face in this area.

1 At the time of writing, the authors were members of Macroeconomic Group in the Treasury. The views in this article are those of the authors and not necessarily those of the Australian Treasury or the Australian Government. The authors would like to thank Gordon de Brouwer, Tony McDonald, Bill Brummit, Olaf Schuermann, Leslie Williams and Hector Thompson for their useful comments.

2 The G-20 comprises the finance ministries and central banks of Argentina, Australia, Brazil, Canada, China, EU (represented by the current, rotating presidency of the EC), France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, UK and US. The IMF and World Bank participate on an ex-officio basis.

Introduction

The Group of 20 (G-20) remains the most legitimate global economic forum for influencing the direction of major global economic and financial governance issues. It is a key vehicle for advancing Australia's strategic interests, particularly with key emerging market economies such as China and India, complementing our regional engagement efforts through other forums such as Asia-Pacific Economic Cooperation (APEC) and the East Asian Summit.

Australia has been an active member of the G-20 since its inception in 1999, highlighted by our 2006 host year and membership of the G-20 management committee ('troika') from 2005 to 2007.[3] Australia particularly values the specific make-up of the G-20 membership and the opportunity this affords the forum to act as a circuit breaker for difficult global issues.

While the G-20 has maintained its core policy discussions relating to strengthening the Bretton Woods Institutions, domestic financial systems, and monetary and fiscal frameworks to help ensure international global financial stability, over time we have seen an increased breadth of issues included for discussion by Ministers and Governors. The inclusion of fiscal space topics in the G-20 work program for 2007 and 2008 is a good example of this, highlighting the importance of this issue for the major economies of the world and recognising its international dimensions.

Fiscal space is certainly not a new issue; it represents the traditional budget problem of how best to prioritise and evaluate government spending against the cost of raising revenue. However, it has been the subject of renewed interest in international policy discussions of late. The recent scaling-up of aid flows by developed countries — associated with the Millennium Development Goals — has drawn additional attention to the fiscal space debate in low-income countries.

Fiscal space is also an important issue for developed and major emerging market economies. The principles of sound fiscal management and budgetary flexibility (embodied in the concept of fiscal space) contribute to improved economic stability, competitiveness and living standards, regardless of a country's income level.

This article highlights the importance of fiscal space for G-20 countries and outlines some of the contemporary challenges they are facing in this area.

3 For further information on Australia's experience as G-20 host in 2006, see de Brouwer and Yeaman (2007).

The importance of fiscal space

'Fiscal space' can be defined as 'the capacity of a government to provide financial resources for a desired purpose, subject to the constraint that the fiscal position is sustainable, both over the medium and long-term' (Heller 2007). Fiscal space is certainly not a new issue; it represents the traditional budget problem of how best to prioritise and evaluate government spending against the cost of raising revenue. However, it has been the subject of renewed interest in international policy discussions of late.

To maintain strong economic growth and rising living standards, all countries need the financial capacity to invest in essential social and physical infrastructure. Demands for new infrastructure vary between countries and are always changing as new economic challenges emerge. For example, taking advantage of breakthroughs in technology requires a higher level of investment in education, research and development and communications networks. Improving transport infrastructure (roads, rails and ports) can help commodity exporters reap the full benefits from the current global commodities boom. Climate change will require investment in new infrastructure that encompasses cleaner technologies.

Most G-20 countries are able to raise funds in domestic and international capital markets at a relatively low cost, and the risk of government insolvency is low. Yet failure to create or maintain adequate fiscal space is likely to bring considerable costs. The consequences will likely be higher debt (with associated servicing costs), increased taxes or the need to reduce government spending. This is likely to be both politically unpopular, and harm economic growth and social well-being. It can also impair macroeconomic management, putting upward pressure on inflation and interest rates, and distorting consumer and business incentives. In most cases, early action to address a potential fiscal risk leads to significantly lower costs than when action is delayed.

Even if a government's overall fiscal position is sustainable over the medium to long term, improvements can further boost incentives and social and economic outcomes. In a highly competitive global economy, countries are continually looking for ways to gain an economic edge.

Creating and maintaining fiscal space

There are a number of well-established tenets of good fiscal management that are commonly adopted by most G-20 (and many other) countries.

It's widely accepted that a prudent medium-term fiscal framework can contribute to fiscal sustainability. Such a framework allows both tax and expenditure policies to be comprehensively and jointly assessed against a government's broad strategic priorities and stated fiscal objectives. For example, the Australian Government's fiscal strategy aims to ensure sustainability through achieving budget surpluses, on average, over the medium term.[4]

The benefits of longer-term (or intergenerational) fiscal frameworks are also being increasingly examined and recognised by G-20 countries. Current government policies can have significant, long-lived and often unforseen implications for the future fiscal position over time, and hence the welfare of future generations. For example, demographic change (population ageing or rapid growth) is a long-term issue of particular concern to many G-20 countries. In Europe and Japan, the combination of an ageing population and rising health costs is already placing significant pressure on the fiscal position.

If these risks are identified early, through intergenerational estimates, measures can be put in place to prevent or ameliorate fiscal stress. In Australia, the *Charter of Budget Honesty Act 1998* requires that an Intergenerational Report (IGR) be released regularly to assess the long-term sustainability of current Government policies over the following 40 years. Although economic projections over such extended time horizons will inevitably be imprecise, intergenerational reporting can provide a general indication of where fiscal stress is most likely to emerge. The IGR can also be instrumental in helping to build public support for changes to existing unsustainable policies by identifying the need to address the emerging fiscal gap and improve the government's long-term fiscal position.

Transparency is another accepted hallmark of good fiscal management (and good public sector governance more generally). Fiscal transparency makes those responsible for the design and implementation of fiscal policies more accountable, reducing the power of special interest groups and leading to stronger, more credible policies that are likely to improve fiscal space and benefit the community.

The IMF has outlined the key elements of fiscal transparency as being:

- roles and responsibilities in government should be clear;
- information on government activities should be provided to the public;
- budget preparation, execution, and reporting should be undertaken in an open manner; and
- fiscal information should attain widely accepted standards of data quality and be subject to independent assurances of integrity (IMF 2007).

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4 This strategy is supplemented by secondary objectives of keeping taxation as a share of GDP on average below the level for 2007-08 and improving the Australian Government's net financial worth over the medium term.

Contemporary challenges to fiscal space

There are a number of contemporary challenges facing G-20 countries seeking to create and maintain fiscal space. These challenges have been the core focus of discussions in the G-20 (and also in APEC).

Institutions to support the budget process

A sound fiscal framework encourages policy-makers to take a comprehensive view of the costs and benefits of their tax and expenditure decisions. The institutions that support the budget process must also be equally well-designed and properly implemented.[5] These institutions can be 'hard', such as legislation, rules and regulations or 'soft', such as codes of conduct, guidelines or cultural norms. Indeed, in 2007, G-20 Ministers and Governors noted that the 'design of effective medium-term fiscal frameworks and the institutional underpinnings of successful national budgeting' are important factors in finding and creating fiscal space (G-20 Ministers and Governors Communiqué 2007).

This year in Brazil, G-20 Ministers and Governors will focus on the importance of budgetary frameworks and processes for evaluating and prioritising spending.

Strong institutions can prevent budgetary processes from being circumvented, including limiting spending being approved outside of the budget process; reduce the potential for corruption; and help ensure that new policy proposals receive adequate and comprehensive evaluation and assessment. In general, a strong central budgetary coordination agency can assist in encouraging adherence to the budget process, including any fiscal rules or targets (Krogstrup & Wyplosz 2006).

It is also important to have the appropriate institutions that ensure individual spending programs (and tax policies) are implemented efficiently. Traditional indicators of fiscal space at the macro level can sometimes mask significant inefficiencies at the micro level. The use of performance-based budgeting, ex post evaluations of government programs and comprehensive spending reviews are all being investigated within international forums like the G-20 with the aim of improving the efficiency of government expenditure.

Questions have been raised around the effectiveness of existing performance-based budgeting. According to Schick 'Efforts to budget on the basis of performance almost always fail …' (Schick 2005, p 9). However, work by the IMF has been more

5 There is extensive literature showing that the institutional framework supporting the budget processes has an important effect on fiscal outcomes. See *Fiscal Institutions, Fiscal Policy and Sovereign Risk Premia*, Hallerberg and Wolff (Deutsche Bundesbank, ZEI-University of Bonn, UCIS-University of Pittsburgh) Discussion Paper Series 1: Economic Studies No 35/2006.

supportive. Drawing on experience of performance-related expenditure reallocations in countries such as Australia, New Zealand and the United Kingdom, the IMF notes that 'although there has been little close empirical study of the role of performance information … there is reason to believe that this role may have been substantial' (Robinson and Brumby 2005).

Engagement with the private sector

The increased focus on efficiency has also led to greater private sector involvement in the provision of government services, especially in the form of public private partnerships (PPPs).

While this issue is not currently part of the discussions within the G-20 forum, identifying and managing the fiscal risks associated with PPPs is the subject of continuing work within the APEC Finance Ministers' Process.

The primary rationale for entering into a PPP should not be the creation of fiscal space. Rather it should reflect benefits that relate to risk sharing and efficiency — for example in cases where the private sector has the expertise or infrastructure necessary to provide a service at a lower cost than the government (Dickson & Lim 2007).

In many cases, PPPs can be a successful means of sharing costs between the public and the private sector. But there can be significant fiscal risks involved. Therefore, it is important that PPPs are carefully structured, with all the costs and benefits over the life of the project clearly identified. This is particularly true if a PPP includes a contingent liability (such as a guarantee of future revenue) that may result in significant off-balance sheet liabilities for the government. Attempting to measure and publicly report any contingent liabilities that arise from a PPP can help address this risk. It is also important that decisions regarding PPPs are taken within the broader budgetary framework so they can be properly assessed against other competing priorities. Identifying and managing the fiscal risks associated with PPPs is the subject of work within the APEC forum.

Wealth and stabilisation funds

Temporary surges in government revenue, while undoubtedly welcome for recipient countries, also present challenges for fiscal sustainability and the maintenance of fiscal space. They complicate budgetary planning, and may encourage governments to spend at unsustainable levels, while creating expectations that this spending will continue indefinitely. Increased revenue may also lead to insufficient attention being paid to the quality of investment projects, leading to inefficiencies. For resource-rich countries, governments need to consider the intergenerational implications of exhausting resource endowments and the extent to which the proceeds should be saved or invested for future generations. The current commodity price boom makes these issues of key interest to many G-20 countries.

In some countries, funds flowing from increases in revenue are being quarantined in sovereign wealth funds (SWFs), thereby enhancing fiscal space, investing for future generations and offsetting future liabilities. SWFs can also allow governments to smooth taxation over time, thus providing a more stable and predictable macroeconomic environment. Large current account surpluses among the export-orientated economies of East Asia are also contributing to the rise of SWFs (Devlin & Brummitt 2007).

In 2007, G-20 Ministers and Governors discussed the challenges of ensuring SWFs best serve their intended purpose (G-20 Ministers and Governors Communiqué 2007). Regardless of whether a SWF is established for stabilisation, savings or both, it is important that appropriate governance arrangements are established. SWFs should have clear overarching objectives; rules and operations that are transparent and free from political interference; clear asset management strategies and investment mandates; and have requirements for regular public reporting and independent audit and assessment of investment performance. It is also important that these funds complement and are integrated with the government's medium to long-term fiscal strategy.

Fiscal decentralisation

Most G-20 countries have a decentralised system of government, involving central, regional and local levels. There is no consensus on the ideal level or form of decentralisation. But well-designed arrangements, that promote close links between spending decisions and the preferences of the local population, can improve fiscal space by enhancing the efficiency of government spending.

However, coordination and accountability for public spending between different levels of government is often a challenge. Where this is the case, attempts to improve fiscal space at one level of government may simply shift the fiscal burden onto another level. A lack of coordination can also restrict the central government's ability to conduct macroeconomic management through the budget (Ter-Minassian & Fedelino 2007). Furthermore, sub-national levels of government may not feel bound by fiscal rules or frameworks, if implied guarantees from the central government exist. In 2007, G-20 Ministers and Governors noted that 'the coordination of expenditure across tiers of government can also be important for the overall coherence of efforts to create fiscal space' (G-20 Ministers and Governors Communiqué 2007).

Conclusion

In countries where the risk of crisis or insolvency present in some developing countries is not so stark, there could be a tendency to take good fiscal management for granted. The G-20 has recognised that good fiscal management is not just about being in the black. It is also about being able to recognise and finance spending that enhances social and economic development in a highly competitive global economy. The consequences of getting this balance wrong are real and significant.

Countries are looking for new ways to improve their frameworks and institutions to ensure they have adequate fiscal space. The fact that this topic is on the agenda of a key international forum such as the G-20 highlights the importance of this issue to the major economies of the world. Through its membership of the G-20, Australia is seeking to share our experience and draw on the lessons of other developed and developing economies.

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