

# Assessing Fiscal Policy in an Accrual Environment

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*This paper was presented by Mr Michael Clark-Lewis, Director, Fiscal Framework and Reporting Section, Fiscal Policy Division, Treasury to the Accrual Budgeting Conference on 18 September 1997. The presentation examines the implications of the Government's adoption of accrual budgeting for assessing the impact of fiscal policy on the economy.*

## INTRODUCTION

My talk today examines the implications of accrual reporting for assessing government performance at the aggregate level. In particular I wish to focus on the relevance of accrual measures for assessing the impact of fiscal policy on the economy.

Along the way I wish to draw out some of the differences between businesses — the traditional users of accrual reporting — and government and the implications of these differences for measuring aggregate government performance under an accrual framework.

## EVALUATING FISCAL MEASURES

In assessing overall government performance two distinct aspects can be identified. One is to assess how a government is managing its own finances: is the government's fiscal position financially sound and sustainable? The other is to measure how the government is affecting the economy.

It is the second of these themes that is unique to government. Business is not concerned with the effect of their activities on behaviour in Australia as a whole. However, for governments the economic consequences of their actions are important.

This economic focus is evident in the Government's medium-term fiscal strategy — outlined in the 1997-98 Budget Papers — which is to follow as a guiding principle the objective of maintaining an underlying budget balance on average over the course of the economic cycle. This approach seeks to ensure that over time the Government saves enough to cover its investment needs and so does not make a direct contribution to the national saving-investment imbalance.

The Government's medium-term fiscal strategy reflects the importance the Government places on raising national saving relative to national investment, thereby reducing the current account deficit and raising longer-term growth prospects.

## MEASURING FISCAL POLICY IN A CASH ENVIRONMENT

### Budget Deficit

The headline budget deficit measure was for a long time the primary aggregate fiscal measure. It was used to assess both the economic impact of fiscal policy and the soundness of fiscal policy. Few users would stop and think about the nuances of these two perspectives; however, as I will discuss later these differences are important, particularly in an accrual environment.

The budget deficit is of course a cash measure, reflecting the fact that the Commonwealth, in common with virtually all governments in the world, currently reports and budgets on a cash basis. That is to say it records all transactions at the time payments are made.

The budget deficit is defined as government spending (including both capital and current spending as well as net advances) less government revenue. The deficit indicates whether a government is able to finance all its expenditure in any year with the revenue it raises in that same year. That is, it provides an indication of the government's net financing requirement.

### Measuring Economic Activity

In addressing the economic effects of fiscal measures it is appropriate to relate these measures to the national accounts — our primary tool for measuring economic activity. Within the national accounts the concept of **net lending** is the key measure for assessing the direct economic impact of government spending and taxation decisions on economic activity.

Net lending represents the extent to which the government provides or withdraws net resources from other sectors of the economy. Typically the government is a net borrower (ie, has a negative net lending position).

Net lending is the balance between government saving and investment. It represents the direct impact of government spending and taxation policies on domestic demand. The government's net lending position also directly contributes to national net lending (which is the sum of each sector's net lending position). National net lending measures the economy's call on foreign savings which in turn is reflected in the current account deficit.

Net lending is thus a particularly important measure of fiscal policy: it provides information on the direct impact of fiscal policy on domestic demand and national saving.

It is appropriate therefore, when assessing the economic impact of fiscal policy, that we choose a measure that closely approximates the national accounts net lending measure. For this reason, the current Government adopted the **underlying deficit** as the primary measure of fiscal policy in March 1996.

The underlying deficit abstracts from a class of transactions termed net advances that do not typically affect economic production. Net advances comprise equity asset sales/purchases and policy lending.

- Equity asset sales and purchases represent a change of ownership but do not of themselves represent a change in economic activity as no new production takes place.
- Policy lending, such as loans to State Governments, are generally a financing transaction. Such transactions do not directly affect economic activity: this only occurs when the funds are spent by the borrower.

While the adoption of the underlying deficit was primarily motivated by a desire to better match the measure of fiscal policy with the Government's macroeconomic policy objective, it also has advantages in assessing the soundness of the government's fiscal position. This is because the two transactions excluded — policy lending and asset sales — do not affect the government's balance sheet and so do not affect the government's overall financial position.

In summary, the underlying deficit improves on the headline deficit for measuring both fiscal sustainability and the economic impact of fiscal policy.

## **MEASURING FISCAL POLICY IN AN ACCRUAL ENVIRONMENT**

### **Accrual Measures and Economic Impact**

Having adopted the underlying deficit measure, an important question is how the introduction of accrual accounting may change the measurement of fiscal policy.

The main difference between cash and accrual accounting is the time when transactions are recorded. The accrual framework attempts to measure all flows at the time economic value is created, transformed, exchanged, transferred or extinguished. The cash framework measures flows when payment is made.

The national accounts framework recommends measuring all transactions on an accrual basis. However, government transactions in the national accounts

are not fully on an accrual basis, reflecting data limitations due to the use of cash accounting by Commonwealth and State Governments.

The adoption of accrual budgeting and reporting by Commonwealth and State Governments will affect both the national accounts<sup>1</sup> and budget presentation of government transactions. In making this change the appropriateness of available fiscal measures needs to be reassessed.

Before turning to those issues, it is pertinent to examine why the national accounts favour the accrual basis of recording transactions. There are two reasons:

- it ensures consistency of timing between transactions. An advantage of the accrual framework is that economic flows such as the profitability of productive activities can be measured without distorting leads and lags in actual cash payments; and
- it allows for the measurement of non-monetary flows which can affect economic well being and behaviour.

The accrual measurement of transactions can more accurately reflect when productive activity is taking place, avoiding distortions that can arise from leads and lags in actual cash payments. However, an accrual transaction basis is not unequivocally superior in measuring the direct economic impact of transactions. An example is the treatment of accruing superannuation entitlements (accumulated by eligible employees over their working life). Under the accrual framework accruing superannuation entitlements are treated in the same way as other income. The accrual approach recognises that accruing entitlements will influence personal spending and saving behaviour. However, it is not clear that an extra dollar received in superannuation entitlements will have the same impact on consumer spending as an extra dollar in cash even though the accruals framework treats them exactly the same. In this case an extra dollar of cash income may have a more direct effect on an individual's spending and saving behaviour and hence a more immediate impact on economic activity.

The Government's adoption of accrual accounting will allow the national accounts to more fully record government transactions on an accruals basis. Nonetheless, the national accounts will continue to use the net lending concept discussed earlier for measuring the budget's economic impact. At issue is whether standard accrual accounting measures, such as the operating balance and the change in net assets (also termed change in net equity or change in net worth) will enable us to approximate the national accounts measure of government net lending when it changes to an accruals basis.

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1 The principal change will be the inclusion of accruing superannuation entitlements as a government expense instead of the cash expenditure on superannuation. Further changes will also occur due to the implementation of the international *System of National Accounts 1993*, which updates the United Nation's 1968 *A System of National Accounts*.

A key feature of net lending is that it takes account of the acquisition of capital, whereas standard accrual measures only take account of the consumption of capital. This reflects the different perspective of the national accounts, which is to measure production, compared to the standard accrual presentation which focuses on resource use. These two perspectives are illustrated when we compare the effects of the government operating a motor vehicle for a year and purchasing a new motor vehicle.

- If the government runs a motor vehicle for a year then it will have consumed part of the life of that motor vehicle. The standard accrual presentation records that consumption of resources in the form of depreciation.
- However, the direct economic consequences of running a motor vehicle for a year are minimal compared to the consequences of purchasing a new motor vehicle. When the government purchases a new motor vehicle it is directly contributing to the employment of labour and capital used in producing that motor vehicle.

The national accounts records both the consumption of capital and new investment in capital. For example, saving in the national accounts takes account of the consumption of capital. However, in deriving net lending the acquisition of capital (equivalent to the change in the stock of new capital assets on the government's balance sheet) is included and the consumption of capital excluded. In this way, the national accounts net lending measure adopts the accrual timing of transactions but also takes account of the acquisition of capital to more accurately measure the government's direct impact on economic activity.

It follows from my discussion that the underlying deficit may no longer be an accurate approximation of net lending once the national accounts begin to reflect the additional information that the Government's adoption of accrual reporting will provide. In addition, because of the different treatment of capital in the national accounts, standard accrual measures (such as the operating balance and change in net assets) will not be appropriate for measuring the economic impact of fiscal policy.

However, the Government will be able to continue to include measures in government finance statistics that closely estimate net lending as measured in the national accounts. Moreover, the potential exists for net lending in the national accounts and government finance statistics to be calculated in exactly the same way. However, at this stage it is unclear whether this will be fully achieved. This reflects a number of differences that exist between the accounting and national accounts frameworks in the treatment of certain transactions. These issues are still being worked out. Nonetheless, the adoption of accrual accounting by the Government will bring government financial accounting closer to the approach recommended in the national accounts.

## Accrual Measures and Financial Sustainability

My preceding comments do not in any way imply that standard accrual measures are inadequate for assessing the financial sustainability of government. Indeed, the focus of standard accrual measures on current transactions, while a drawback for assessing economic impact, is an advantage for assessing financial sustainability.

This is evident when considering the features of the two most common accrual measures: the operating balance and change in net assets.

The **operating balance**, defined as revenues less expenses, provides a measure of government saving. A valuable feature of the operating balance measure is that all costs involved in providing government services are included, such as depreciation and employee superannuation, not just cash costs. Hence if revenues are set to match expenses, then the government will be able to maintain the current level of services over time. In contrast, cash measures do not encompass all transactions, so that accruing superannuation and depreciation expenses may create the need for future fiscal adjustments even when the budget is in balance on a cash basis.

The operating balance is a useful measure of fiscal sustainability because it directly addresses the ability of governments to sustain existing services.

Another aggregate accrual measure is the **change in net assets**, which is equal to the operating balance plus any revaluation of assets and liabilities. The inclusion of balance sheet revaluations can provide additional information in assessing the sustainability of the government's position. In particular, if the government's assets rise in value then this improves the government's financial position by increasing the asset base on which the government can draw.

However, it should be kept in mind that the factors affecting asset valuations are generally outside government control and that increasing asset values could potentially obscure otherwise unsustainable government policies. Therefore, while this measure is useful it should always be considered in the context of the operating balance.

It should also be recognised that it is difficult to value many government assets as they are not normally traded. This can affect the interpretation of changes in the value of government assets.

Asset and liability revaluations may also create a degree of volatility in the change in net assets measure without necessarily changing the ability of governments to pursue their objectives. Further, increasing values for depreciable assets will have the second round effect of increasing expenses in the future as the cost of replacing those assets will have risen.

## **STOCK MEASURES**

So far I have focused on the flow measures within the cash and accrual frameworks. However, a range of stock measures is also available for assessing the government's fiscal performance. These measures are primarily used to assess the sustainability of the government's fiscal stance rather than for assessing the economic consequences of policy.

Under the current framework, net debt is the primary stock measure. Net debt is defined as the difference between selected financial liabilities and assets and shows the cumulative amount of net borrowing that the government has undertaken over time to finance its expenditure. High levels of net debt impose a call on future revenue to finance interest payments and reduce the flexibility governments have to adjust outlays. Therefore, high debt levels typically raise questions about the sustainability of a government's financial position.

The accrual net asset measure extends net debt to report on the total net asset position, by bringing physical assets into account as well as additional financial assets (such as equity) and liabilities. The key advantage of the net asset measure is that it recognises the value of capital assets which may be financed by borrowing.

This is an important distinction, since it is widely accepted that borrowing to finance capital assets can be readily justified as these assets provide a flow of services over time that can offset the stream of borrowing expenses. In contrast borrowing for sustained periods to finance current spending will lead to an accumulation of liabilities with no offsetting assets.

The inclusion of non-financial assets allows a more complete assessment of the strength of the government's fiscal position. However, as noted earlier, it is difficult to value some government assets and not all will necessarily be saleable (for example, it is impractical to sell most city roads). It is important therefore not to presume reported government assets can readily be sold in order to repay debts.

## **APPLYING ACCRUAL MEASURES TO GOVERNMENT**

The foregoing covers the main issues that need to be considered in selecting aggregate fiscal measures. My following comments highlight the need for users to ensure they fully understand the available measures and their relevance to government.

## Objectives

It is important to recognise that just because the Government is to adopt the accrual framework currently used by business the resultant measures cannot necessarily be interpreted in the same way as for businesses.

First, as I have outlined, governments have different objectives to business, such as managing economic conditions. For this reason a measure that approximates national accounts net lending needs to be applied. This is not a criticism of standard accrual measures, rather a recognition of the need to assess the relevance to government of measures designed for business.

Second, governments have unique powers, such as the capacity to tax, that business do not possess. Thus whereas a business with a negative net asset position is unlikely to be able to raise additional funds for investment and would be regarded as insolvent, for government this is not the case. Governments may be able to sustain a negative net asset position for a considerable period of time, and indeed this may be an appropriate course of action, because of its capacity to raise taxes in the future. This capacity to tax suggests that standard accrual measures do not fully measure the financial strength of governments since the capacity to raise revenue through taxes is not included.

## Coverage

Another reason why caution should be exercised in interpreting accrual measures relates to their scope and coverage.

As with all measures, the accrual framework generates some grey areas in terms of classifying transactions. Sophisticated users of statistics need to be aware of these issues and take them into account in interpreting the measures. This is no different to the adjustments we discussed earlier in deriving the underlying deficit to better measure the economic impact of fiscal policy.

An example is the respective treatment of employee superannuation and pensions. As we have discussed, under the accrual framework superannuation expenses are recorded as they accrue. However, pension entitlements are not considered to accrue over time but rather become payable when the eligibility criteria are met. Therefore, accrual measures will not include any information on future pension outlays. There is a sound justification for this treatment; however, it cannot be denied that governments have implicit commitments to pay pensions in the future. Moreover, taxpayers will be interested in information on the likelihood of these commitments being met: a question standard accrual measures cannot answer. The lesson here is that users must be aware of what transactions are included in the accrual measures before drawing conclusions.



## CONCLUSION

In concluding, there are three main issues I wish to highlight. First, in determining which accrual measures are most relevant to government it is important to consider the economic focus that is unique to government. This focus is central to the operations of government — as embodied in the Government's medium-term fiscal objective.

Second, accrual measures can provide a good indication of both the economic impact and the sustainability of fiscal policy.

- As discussed, the standard accrual measures — operating balance, change in net assets and net assets — can assist in assessing the sustainability of fiscal policy. In addition, the national accounts net lending measure is particularly suited to assessing economic impact.

Finally, the adoption of accrual budgeting will introduce a suite of new fiscal measures and we need to understand the features of these measures and to take particular care to ensure the different features of government compared to business are taken into account when interpreting the results.