

[ECONOMICS: STEPHEN ANTHONY]

Fixing the Commonwealth's broken

Spending cuts

Australia remains vulnerable to a future debt crisis, and must start pruning its public spending now

Treasurer Wayne Swan argues that the budget should return to surplus by 2012-13. This compares favourably to budget deficits of about 10 per cent of gross domestic product now being run by countries such as Britain. Clearly, there is no need for the Australian Government to undertake a significant fiscal austerity program such as the £83 billion (\$A134 billion) in spending cuts announced by the Cameron Government last week. Right?

Well, *Macroeconomics' Mid-year Budget Bulletin*, issued last month, reveals the Commonwealth structural budget (i.e. budget balance adjusted for movements in the business cycle and commodity prices) is now in a cash deficit by about \$58 billion in 2010-11 (about 4 per cent of GDP), and will hardly decline in dollar terms over the outlook period. It is still expected to be in deficit by about \$49 billion (or 3 per cent of GDP) in 2013-14.

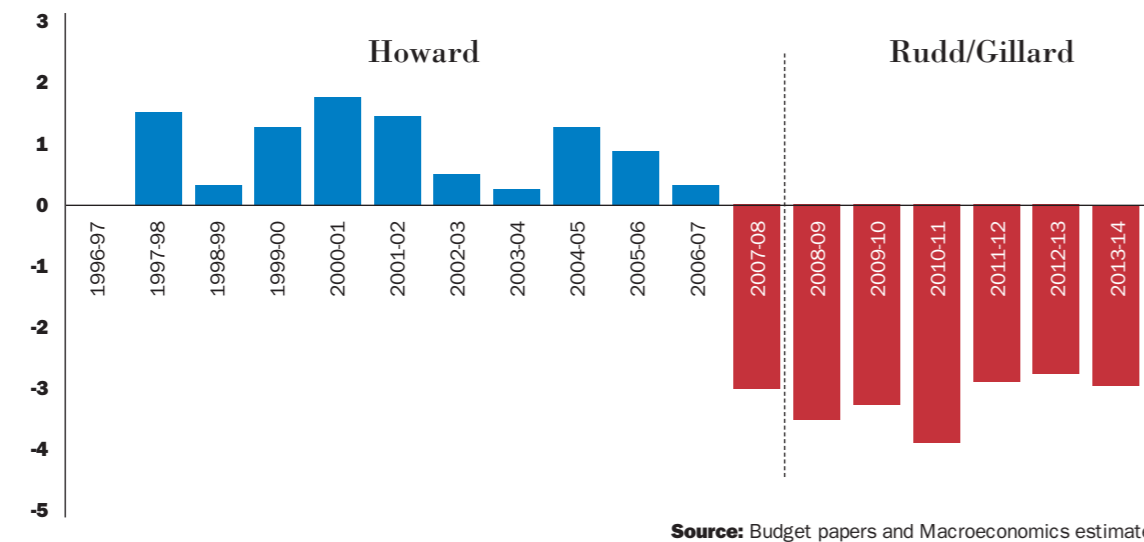
So when did the structural budget such a pig's breakfast? Having returned the budget to a structural surplus, the Howard government achieved structural budget surpluses averaging 1.1 per cent of GDP between 1996-97 and 2002-03. However, from the advent of "China Boom 1" in 2004, successive tax cuts and a significant discretionary policy-easing saw the bottom line deteriorate quite rapidly, so that, by 2007, the federal budget was in structural deficit before the 2007 election spend-a-thon. The rapid deterioration in the structural budget position is now such a big problem that even the Treasury is publicly expressing its concern. Treasury broke new ground in a recent *RoundUp* article by detailing publicly the depth of the problem to which both major parties have contributed.

Unfortunately, successive governments failed to "bank" the windfall gains from the terms of trade boom



The way forward: Treasurer Wayne Swan must start finding real savings, not simply wind down existing stimulus spending.

FEDERAL STRUCTURAL BALANCES



Source: Budget papers and Macroeconomics estimates

that began in 2004-05, instead deciding to either provide tax cuts or spend the windfalls. Higher terms of trade mean rising nominal GDP, which translates to rising federal tax receipts driven primarily by income tax collected from individuals and businesses. We estimate the total benefit to

the budget bottom line from 2010-11 onwards is likely to be over \$30 billion or about 10 per cent of total receipts. Over the 10 year-period to 2013-14, we estimate China's booms 1 and 2 will add a staggering \$230 billion to the federal budget's bottom line.

Nor has the Rudd-Gillard Government displayed much fiscal discipline, even allowing for the global financial crisis-inspired fiscal stimulus. By our reckoning, in the 2010-11 budget rounds since it came to office, it has new net discretionary spending (including fixed-assets purchases)

totalling \$113 billion, including temporary stimulus spending worth about \$70 billion. Currently, the rate of real policy spending growth is averaging over 3.8 per cent over the forward estimates, removing the effect of the stimulus. Right now, the Government's commitment to a 2 per cent real spending growth cap is being achieved by phasing down the stimulus measures from base spending (very clever). Further, there are significant new spending pressures on the horizon (from 2014-15) given the Rudd-Gillard Government's practice of pushing major spending decisions just beyond the budget outlook (for example, environmental policies, defence purchases, major infrastructure and, now, the Independent MPs' demands).

To ensure budget surpluses in 2012-13, the Gillard Government must tackle the pesky structural budget deficit by cutting the discretionary spending base and capping new policy decisions. To eliminate the large structural deficit over the budget outlook requires a fiscal austerity package of about 2 to 3 per cent of GDP, or \$30 to \$40 billion over 24 years. In terms of administered spending, the focus of any savings round should be middle and upper-class welfare recipients. We say spread the pain of adjustment as thinly as possible and impose the largest burden on those likely to benefit from an upswing in the business cycle. In terms of departmental spending, the focus should be raising agency productivity. If public sector job cuts are needed, don't apply them indiscriminately but use packages to identify individuals in agencies with low productivity and provide them a way forward to a more rewarding career. We have time to achieve staff reductions that will genuinely help to raise the efficiency of government.

Nor could a savings round be better timed in the business cycle, with an economy likely to grow at about 4 per cent of GDP in 2010-11 and with federal and state investment spending potentially crowding out private investment activity.

But public debt is low in Australia, so why should we worry about the structural deficit? Well, a structural deficit implies that more normal levels of commodity prices and

budget: the case for fiscal austerity

COMPOSITION OF TERMS OF TRADE TAX RECEIPTS

	Actual						Estimates		Projections		Total
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	
	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b	\$b	
Gross income tax withholding	2.4	5.5	7.4	9.2	12.9	11.1	17.1	18.6	18.2	18.0	120.4
Company tax	1.3	3.5	5.2	6.6	9.0	6.5	11.2	13.1	12.8	12.6	82.0
Gross other income	0.6	1.3	1.8	2.4	3.3	2.4	3.8	4.2	4.1	4.1	28.1
Total tax revenue gain	4.3	10.3	14.4	18.2	25.2	20.1	32.1	35.9	35.2	34.6	230.4

Source: Budget papers and Macroeconomics estimates

economic activity would see the Commonwealth accumulating significant public debt. And right now, total public sector financial liabilities (federal and state) will still approach \$300 billion by 2013-14 (about 20 per cent of GDP) even given the current 50-year high commodity prices. And

fiscal sustainability policy challenges remain, with the burden of an ageing population looming, significant defence equipment spending necessary, and with superannuation tax concessions not modelled in the *Intergenerational Report* now worth \$32 billion and set to cost the federal

budget about \$170 billion by the middle of next decade. The bad news is that Australia in 2010 already has net external liabilities of about \$768 billion, or 60 per cent of GDP, so any future sovereign "debt" crisis (such as that presented by Greece in April 2010) may hit us very hard.

While Australia has a healthy banking system, strong trade links with the fastest-growing region in the world, and small public indebtedness, our private sector heavily relies on net capital inflows to fund future growth. For this reason alone, Australian governments always need to maintain

world's best fiscal strategy by articulating the way forward to more sustainable finances.

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REAL SPENDING GROWTH UNDER RUDD-GILLARD

	Actual	Estimates		Projections	
	2009-10	2010-11	2011-12	2012-13	2013-14
	\$b	\$b	\$b	\$b	\$b
Payments spending base	325.7	344.9	351.7	367.5	383.4
Real growth in spending (%)	0.7	3.2	-0.4	2.0	1.8
GFC stimulus spending	25.4	16.2	5.6	-2.2	0.0
Payments spending base (excluding stimulus)	300.3	328.7	346.1	369.7	383.4
Real growth in spending (excluding stimulus) (%)	0.3	6.8	2.9	4.3	1.2

Source: Budget papers and Macroeconomics estimates