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In this Bulletin..

In 1988 a Labor Government faced with a negative terms of trade shock, a huge budget deficit and a strong economy **cut public spending by 2.3 per cent of GDP** in the budget year. In 2008, another Labor Government faced with a positive terms of trade shock, burgeoning inflation, and a strong economy should cut public spending by at least 1 per cent of GDP and cajole the States to make a further 0.5 per cent of GDP in savings.

We forecast the Australian Government Budget Outlook will contribute to underlying inflationary pressures unless the structural integrity of the Commonwealth Budget is restored. Headline surpluses over the outlook averaging $21 billion are respectable, but mask structural deficits of $14 billion on average, a legacy of the fiscal profligacy since the 2001-02 Budget. We **hope** the new Government will achieve $5.7 billion in net savings in 2008-09, which is similar in GDP terms to the $3 billion in savings announced by the last Government in the 1996-97 Budget.

Waste abounds. In recent years fiscal policy has contributed to bottlenecks in the economy, crowding out resource flows to productive sectors of the economy. Irresponsible budget policy and administration has contributed to higher prices and higher interest rates. An 'easy' fiscal policy implies that monetary policy is tighter then necessary. We estimate that the $25 to $30 billion structural deterioration in the budget position of Australian governments since May 2002 is responsible for the bulk of the **300 basis points** tightening of monetary policy. The bulk of the increase in the cash rate is a consequence of the volume and quality of spending by the Australian public sector, lead by the Commonwealth.

Placing more of the adjustment burden on fiscal policy – a better tool to spread the adjustment burden – rebalances macroeconomic policy. It will lower funding costs for business and restore market confidence shaken in the wake of Sub-Prime and strengthen growth prospects. **Bold, immediate, and decisive action** is required by government to create a circuit breaker to forestall a period of high inflation and the downturn that will follow the RBA's prolonged tightening cycle, which is likely to continue into 2009. Failure to act *NOW* risks severely restricting growth prospects over the coming few years, just as a United States' recession and Chinese inflation may end the commodity boom.

What follows is framework for thinking about the most appropriate stance for macroeconomic policy, detailing where and how significant budget cuts can be achieved, along with suggestions for microeconomic reforms which the recent **2020 Summit** missed. Extensive coverage is provided for the Australian and each State or Territory government.

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1 Australian Government: A History of Spending

Our hypothesis is that profligate fiscal policy has lead to higher prices in an era of full employment which has inevitably resulted in higher interest rates. Before the Reserve Bank began the current tightening, interest rates were at a 30 year low at 4.25 per cent in April 2002. Since that point the structural budget position has deteriorated by 2 percentage points of GDP. Over that period interest rates have risen 12 times by a total of 300 bps. Most of the tightening (200bps) has occurred after the 2004-05 Budget was brought down. This Budget is special because by this time most Australian governments were awash with windfall receipts from the housing and/or commodity booms and should have been finding ways to 'save' the windfalls.

1.1 Spending Like Drunken Sailors

While the previous Government made modest spending cuts over its first two budgets (totalling around $8 billion for 1996-97 & 1997-98) this situation had reversed itself by 2001-2002, due to the modest fiscal stimulus introduced to curb the slowdown in activity associated with the introduction of the GST. Unfortunately this episode taught the previous Government the expediency of measures such as the first-home owner's scheme.

Table 1 shows the impact of parameter and policy variations on the budget bottom-line for each budget since 1996-97. It reveals the extent of the poor spending discipline that will be one legacy of the previous Government as well as the extent to which the budget bottom-line was assisted by favourable policy and other variations that were neither 'banked' by government, nor handed back to taxpayers as compulsory saving.

The discretionary easing in policy from 2001-02 was worth around **$27 billion** in new measures, on average, each year. The bulk of the loosening occurred from the 2004-05 Budget onwards, when it was clear to all and sundry that a terms of trade shock was underway – totalling around **$150 billion** over four years.[1] All this spending was thrown at an economy in the mist of a commodity boom. Blind Freddy could have told you the outcome would be **INFLATION**.

[1] This amount includes the impact of new spending policy in 2007-08, but excludes the impact of the new policy on the current budget year and over the forward estimates. Nor does it incorporate the stimulatory impact of tax cuts and the growth in tax expenditures which contributed about the same again to growth from 2004-05.

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Table 1 Impact of Budget Policy Spending From 1996-97

	1996-97* $b	1997-98* $b	1998-99* $b	1999-00 $b	2000-01 $b	2001-02 $b
Budget Balance	**-4.2**	**-2.0**	**3.8**	**11.9**	**5.6**	**-3.4**
Impact of revenue policy decisions	1.0	1.9	1.7	1.1	1.8	-1.2
Impact of spending policy decisions	2.0	5.0	2.9	-5.1	-10.6	-10.6
Effect of Parameter Variations	**-2.0**	**-0.8**	**-1.7**	**9.1**	**5.8**	**-0.5**
Budget Balance with 'no change' to discretionary spending	**-6.2**	**-7.0**	**0.9**	**17.0**	**16.2**	**7.2**
Total cumulative impact of spending policy decisions since the 1996 Election.	2.0	7.0	9.9	4.8	-5.8	-16.4
	2002-03 $b	**2003-04** $b	**2004-05** $b	**2005-06** $b	**2006-07** $b	**2007-08** $b
Budget Balance	**4.7**	**4.8**	**10.8**	**14.8**	**15.4**	**14.9**(e)
Impact of revenue policy decisions	0.5	-4.2	-3.9	-13.8	-19.4	-26.1
Impact of spending policy decisions	-10.4	-20.7	-23.0	-30.1	-41.7	-50.1
Effect of parameter variations	**-0.6**	**9.5**	**21.5**	**37.7**	**56.5**	**61.4**
Budget Balance with 'no change' to discretionary spending	**15.1**	**25.5**	**33.8**	**44.9**	**57.1**	**64.9**
Total cumulative impact of spending decisions since the 1996 Election	-26.8	-47.5	-70.5	-107.5	-149.2	-201.2

Source: ABS, Budget Papers & Macroeconomics estimates.
A positive number for revenue or expenses indicates an improvement in the budget balance. The figures in the table are subject to rounding. *Prior to 1999-2000 figures are based on the underlying cash balance. There are some major comparability issues around the shift to accrual accounting. For example, the above table does not include the recorded removal of revenues and expenses from the Commonwealth General Government in the 1999-2000 Budget for the 2000-01 and 2001-02 years. Reconciliation between years to account for the cumulative impact of decisions and parameters is limited by detail provided in various budget papers so that a dollar for dollar reconciliation is not possible. For example, variations occurring in between the last Budget estimate and Final Budget Outcome have not been reported since 1996-97.

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Throwing a huge stimulus at an economy lacking idle capacity and facing supply-side constraints is highly inflationary, and inappropriate given the state of the economy and trade cycle. This spending 'fever' was overseen by senior ministers with the endorsement of senior officials who publicly lauded the achievements of the medium-term fiscal strategy without making a timely critical analysis of the spending track record.[2]

Table 2 Structural Budget Balance From 1996-97 with Adjustment for Terms of Trade Shock

	1996-97 $b	1997-98 $b	1998-99 $b	1999-00 $b	2000-01 $b	2001-02 $b
Budget Balance	-4.2	-2.0	3.8	11.9	5.6	-3.4
Impact of the Economic Cycle	6.1	7.9	2.6	-4.2	-0.1	13.5
Impact of the Commodity Cycle	-1.0	-1.2	0	-2.3	-2.6	-2.6
Structural Balance	**0.9**	**4.7**	**6.4**	**5.4**	**2.9**	**7.5**
(Per cent of GDP)	-1.1	-0.7	0.2	0.7	0.4	0.5
	2002-03 $b	**2003-04** $b	**2004-05** $b	**2005-06** $b	**2006-07** $b	**2007-08 $b**
Budget Balance	4.7	4.8	10.8	14.8	15.4	14.9 (e)
Impact of the Economic Cycle	0	-5.5	0	8.2	11.0	10.2
Impact of the Commodity Cycle	3.1	4.5	8.7	14.8	17.2	22.4
Structural Balance	**4.7**	**-0.7**	**2.7**	**-5.4**	**-12.7**	**-17.7**
(Per cent of GDP)	0.2	0.0	0.1	-0.4	-1.2	-1.6

Source: ABS, Budget Papers & Macroeconomics estimates.

[2] The distribution and number of new budget measures by the Commonwealth government, along with some analysis of the Australian Public Service over the period, is outlined in more detail in a recent study by Laurie & McDonald (2008).

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1.2 Structural Deterioration in Australian Government Budgets

The most disappointing aspect of the recent fiscal track record was that a large proportion of the gains of previous rounds of economic reforms and the China boom have been frittered away through wasteful spending. Table 2 outlines estimates of the structural balance in Australia over the period 1996-97 to the current year 2007-08 using **Macroeconomics**' structural budget model for the Commonwealth Government and based on the MYEFO before the election. It shows that without the commodity cycle and strong economy, the budget would be in deficit by almost $18 billion dollars (1.6 per cent of GDP).

In addition, various State governments have engaged in structural dis-saving by failing to 'bank' their own stamp duty, land taxes, and mining royalty windfalls since 2002-03, whilst in recent times undertaking a pro-cyclical 'mini' investment boom of their own after two decades of neglect. Collectively State governments accrued a structural deficit of close to $7 billion in 2006-07 which is expected to rise to around $8 billion in 2008-09. This supports the case for a joint permanent discretionary tightening of policy of up to 2 per cent of GDP each year ($25 billion) to support national savings and to mitigate inflation.

Table 3 Structural State Budget Outcomes since 1996-97

	2001-02 $b	2002-03 $b	2003-04 $b	2004-05 $b	2005-06 $b	2006-07 $b
GFS Revenue	135.3	142.7	153.8	162.9	175.1	190.3
GFS Expenses	130.0	138.3	145.0	154.4	165.7	178.5
Net acquisition of non-financial assets	5. 9	5.4	4.8	7.6	11.2	16.2
GFS Net Lending(+)/Borrowing(-)	**-0.6**	**-0.9**	**4.0**	**0.9**	**-1.9**	**-4.4**
Less Windfall Revenue Heads (stamp duties, land taxes, royalties etc.)	0.0	-1.0	-1.3	-1.4	-2.7	-2.3
Structural Budget Balance	**-0.6**	**-1.9**	**2.6**	**-0.5**	**-4.6**	**-6.7**

Source: ABS 5512.0, Budget Papers & Macroeconomics estimates. This tables reports on a total public sector basis which is the most comprehensive measure available to assess the budget position of each state jurisdiction. For the Commonwealth the general government basis is reported because here the difference between general government and total budget sector outcomes is very small.

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Box 1 How Poor Spending Decisions Make Interest Rates Higher

There are basically three ways in which fiscal policy contributes to higher interest rates.

The Output Gap

Movements in short term interest rates are driven by monetary policy and the outlook for inflation which is driven by expectations. The main link between inflation and fiscal policy is the level of activity. By targeting low positive inflation, monetary policy is directed at the 'output gap' between potential and actual output. When the gap is close to zero, policy action which feeds demand spills over into higher prices.

A rule of thumb for measuring the impact of this stimulus on prices for a fully employed economy is **proportionality**, i.e. a **1 percentage point** or $1.2 billion increase in **discretionary spending** in 2008-09 increases **interest rates** by around **1 percentage point**.

Inflation Expectations

Movements in long-term interest rates are driven by a combination of factors such as the condition of the public balance sheet public (as well as inflationary expectations). As the level of public indebtedness increases, investors may require a premium as compensation for holding more government debt in their portfolios. Research undertaken by Treasury suggests that a structural deterioration in the budget bottom-line of around 3 per cent of GDP would add around **100 basis points to yields on long dated securities** (Comley *et al* 2002). It is also suggested that these long term funding costs feed back into shorter term interest rates as inflation expectations build. *This suggests the best remedy for the funding crisis faced by many financial sector businesses in Australia in the aftermath of Sub Prime is a circuit breaker represented by a structural improvement in the Budget by 2-3 per cent of GDP.*

Supply-Side Policies

Poor public administration and low quality spending choices have also contributed much of the remaining inflationary pressure in recent years, encouraging waste and anti-competitive management and labour practices. Evidence can be seen in the growth in **administered prices,** where price changes in certain consumables are determined in large part by government. This includes a large number of items such as utilities, property rates & charges, hospital & medical services, pharmaceuticals, post, education and child care etc., representing around one quarter of the total Consumer Price Index by value. The annual rate of increase in administered prices has been close to 5 per cent since 2001-02 and has consistently outpaced the growth of those consumer prices determined by market forces (Hughes 2005 & **Macroeconomics** estimates). Growth in this index is a good proxy for the failure of competition policy in protected sectors of the economy and a sign of the need for market reforms which can ease cost of living pressures on Australian families and business.

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