Is there still a budget emergency?

National Press Club of Australia

9 October 2013

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1 CONTEXT

In his speech in reply to the 2013 budget, then Opposition Leader, now Prime Minister, Tony Abbott, declared that Australia had “a budget emergency”.

But there are no flashing blue lights. The Australian government budget is not in cardiac arrest on the operating table, needing a triple bypass to keep it alive. We do not have that kind of emergency.

But Australian government budgets are unfit, overweight, and smoking – and now they have high blood pressure and chest pains. Most worryingly, the patient has gone into denial and is eating more cheese.

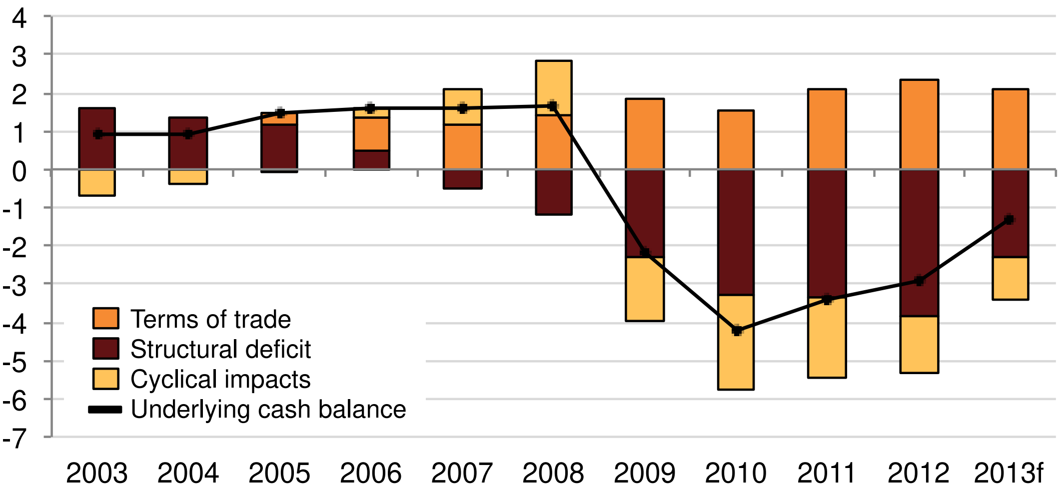
I believe that reform requires a narrative that explains to Australians what happened to government budgets over the last decade, and why we need to get fit and healthy again. Starting now.

2 THE LAST DECADE

2.1 Structural deficits and spending increases

For much of the last decade Australian governments have lived beyond their means. Despite talk about a “structural deficit”, I’m not sure that everyone has absorbed what this means. We may need to spell it out more clearly.

Commonwealth budget balance
Per cent of nominal GDP



Minifie, *The Mining Boom*, p.40

By definition, a structural deficit means that the government is spending more than its income, after allowing for fluctuations in prices (particularly the mining boom and the terms of trade), and the business cycle (particularly the global financial crisis).

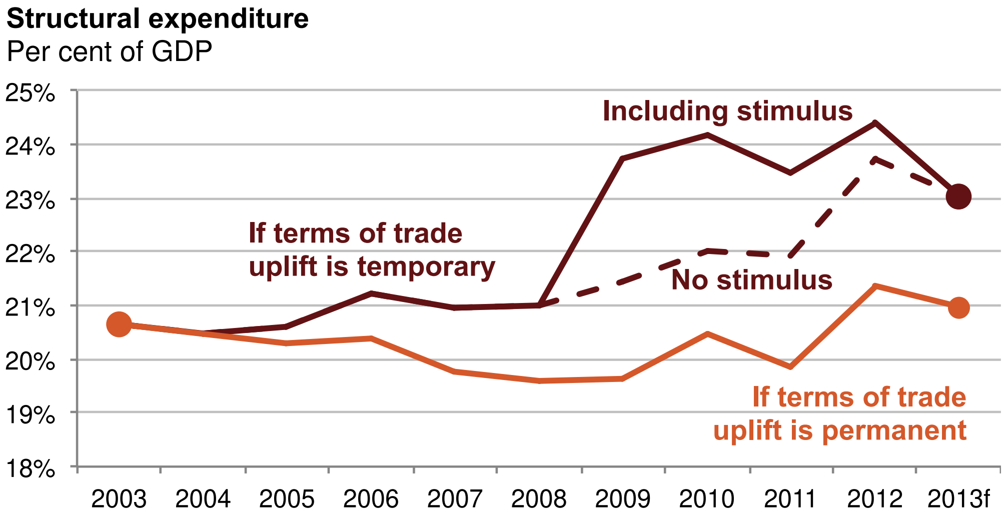
Calculations of the structural deficit by the IMF, OECD, Australian Treasury, the Parliamentary Budget Office, Deloitte Access Economics and Grattan Institute all use slightly different methods and assumptions. But they all come to the same conclusion. The Commonwealth government has had an underlying deficit – after subtracting the effects of the mining boom and the GFC – for the last seven years. This underlying deficit has generally been more than 2% of GDP.[1]

Australia's budget issues have been masked by the mining boom and the Global Financial Crisis. We failed to realise that the income from the mining boom wouldn't last. And we failed to realise that spending increases through the GFC *would* last.

One of the problems is that we often think about government expenditure as a percentage of GDP. In normal times, this is a good rule of thumb. If the massive run-up in the price of iron ore and coal were permanent, then Commonwealth Government expenditure today is only a tick higher than in 2003. But if iron ore and coal prices return to historic levels, then it would be apparent that Commonwealth government spending rose two percentage points in eight years. That is a structural shift.

Of course we could cross our fingers and hope that minerals prices will stay high for longer. But we can only count on this if we have already saved a buffer. We haven't.

This structural shift also escaped attention because of the stimulus package. It looked as though spending was falling in 2012-13. But that fall was the consequence of the stimulus package rolling off, and payments being shuffled between different years. *Underlying* spending had been rising rapidly.

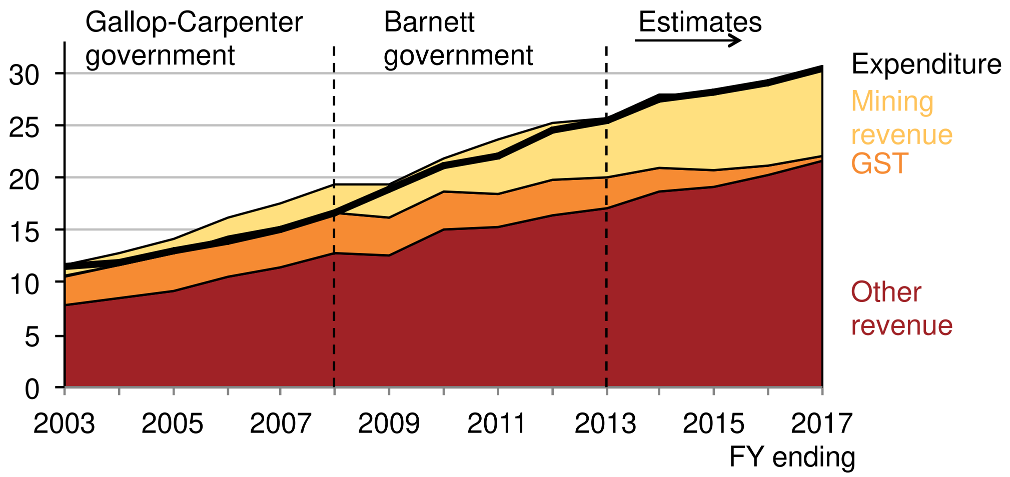


Minifie, *The Mining Boom*, p.42

[1] Daley, McGannon and Savage, *Budget pressures on Australian governments* (2013), Grattan Institute http://grattan.edu.au/publications/reports/post/budget-pressures-on-australian-governments/, p.28; Parliamentary Budget Office, Estimates of the structural budget balance of the Australian Government 2001-02 to 2016-17 (2013) http://www.aph.gov.au/~/media/05%20About%20Parliament/54%20Parliamentary%20Depts/548%20Parliamentary%20Budget%20Office/Parliamentary%20Budget%20Office%20Stuctural%20Budget%20Balance.ashx

These problems also exist at the State level. Western Australia, in particular, has spent *all* of its mining boom windfall on *recurrent* expenditure. With additional capital works it is budgeting for net debt of $28 billion by 2017.[2] Its budget relies on mining prices reaching forecasts.

WA government revenue and expenditure
$b, nominal



Note: 'Mining revenue' includes royalties and North West Shelf payments from Commonwealth. All figures are General Government.
Sources: WA State Budget Paper 3 (various years); WA Overview of State Taxes and Royalties 2012-13;ABS Cat No. 5512.0 Table 235.

Thus Australian government budgets have been using a faulty set of scales, ignoring the evidence of their growing waistline. We will not be able to ignore reality forever.

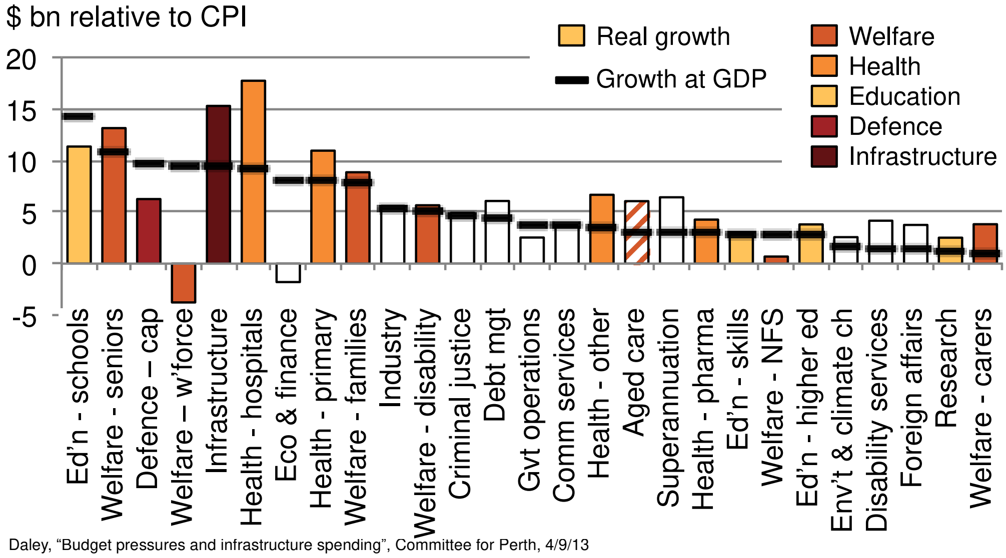
2.2 Health pressures

The structural shift in government spending also escaped attention because the big items don't get much airplay at budget time. Media on the morning after the last Commonwealth budget focused on a billion dollars more or less for the schoolkids bonus. Meanwhile much larger increases in health spending went unremarked. Yet over the last decade health was responsible for most of the spending increases above GDP, for both Commonwealth and State governments.[3]

[2] Department of Treasury, Western Australia, *2013-14 budget: 2013-14 Economic and fiscal outlook: Budget Paper No. 3* (2013), p.50 http://www.treasury.wa.gov.au/cms/uploadedFiles/State_Budget/Budget_2013_14/bp3.pdf

[3] *Budget pressures on Australian governments*, p.15

Change in Australian governments' expenditure 2003-2013
$ bn relative to CPI

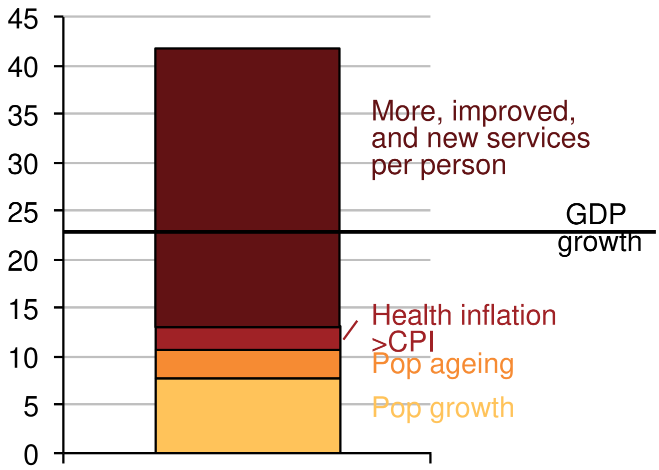


Daley, "Budget pressures and infrastructure spending", Committee for Perth, 4/9/13

There is a reason why governments are spending more on health. Voters want them to. Political sensitivity over hospital waiting lists is acute. Many people are happy to spend more of the country's increasing income to improve their lifespan and quality of life. Interestingly, however, private spending on health hasn't increased so fast – it was 5.1% of household expenditure in 2002, and 5.9% in 2012.[4]

Some believe the rapid growth in health spending is driven by the ageing of the population. This is not true. Health costs have increased primarily because a 60 year old today visits the doctor more often, has more tests, has more operations, and takes more drugs, than a 60-year old ten years ago. The greater number and proportion of 60 year olds has increased health costs a little. But most of the real increase in spending results from providing more and better health services per person.[5]

Real increase in expenditure 2003-2013
($2012 billion)



Grattan Institute, *Budget Pressures on Australian governments*

[4] ABS, "Australian system of national accounts: household final consumption expenditure", Cat. 5204, Table 42. But note that the ABS Household expenditure survey indicates no material change from 5.2% in 2003 to 5.3% in 2009: ABS, "Household Expenditure Survey, Australia: Detailed Expenditure Items, 2009-10", Cat. 6530, Table 3A; ABS, "Household Expenditure Survey, Australia: Detailed", Cat. 6535.0.55.001, Table 2

[5] *Budget pressures on Australian governments*, p.16

We are probably getting something for the money. Life expectancy of those over the age of 65 continues to increase rapidly. In 1970, most men aged 65 expected to die before 78. Today, most men aged 65 expect to live to be over 84.[6] Quality of life has also improved. As the CEO of a cruise ship operator remarked recently, "Modern medical science is [a] gift that keeps on giving! New knees and hips, as well as heart stents – especially heart stents – are giving my customers another 10 to 20 years of travelling".[7]

So the problem is not that governments are wasting our money on health. The question is who is going to pay for it. Over the last decade, the mining boom paid for more health. It was a relatively painless decision. There were no losers. Over the next decade, if health costs continue to increase at the same rate, they will consume an extra two percentage points of GDP by 2023. As the effects of the mining boom unwind, there will be losers. Either people won't get the improved healthcare they want. Or some other area of government expenditure is going to have to be cut. Or someone else is going to pay more tax.

Thus a crude summary of the last decade is that Australian governments received a windfall from the mining boom, and largely spent it on health. And the large stimulus to respond to the GFC was not matched by an equally large contraction to bring government spending back to "normal" levels. As a result, we ran cash deficits in years that should have been in surplus. When minerals prices fall, it will become apparent that the underlying deficits are even larger.

2.3 Eating more

The problems are likely to get worse. Despite its rising cholesterol, Australian governments have signed up to a series of lavish dinners.

The Coalition has promised a number of signature initiatives that will ultimately have a net cost to the budget of around $10 to $15 billion in today's dollars by 2023. There are the costs of abolishing carbon and mining taxes. The Coalition's corporate tax cut, paid parental leave and large corporate levy will collectively drag on the bottom line. In addition, most of the planned costs for DisabilityCare and the Gonski schooling reforms start to bite after 2017, only reaching "steady state" by around 2022.

Welfare costs are also likely to increase. With Newstart payments at levels that leave even the Business Council of Australia uncomfortable,[8] there may be more pressure to increase welfare payments for those who are least well off, especially if the economy turns down. We are also likely to see political pressure to keep increasing aged pension benefits.[9]

A 2013 report for Grattan Institute, entitled *Budget Pressures*, estimated that cumulatively the pressures of health spending, signature initiatives, welfare, and a fall in the terms of trade could reduce the budget balances of Australian governments by four percent of GDP. That's $60 billion in today's terms.[10]

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[6] Daley, McGannon and Ginnivan, *Game-changers: economic reform priorities for Australia* (2012) Grattan Institute, http://grattan.edu.au/publications/reports/post/game-changers-economic-reform-priorities-for-australia/, p.56; ABS, "Deaths", Catalogue 3302.0, Table 3.9.

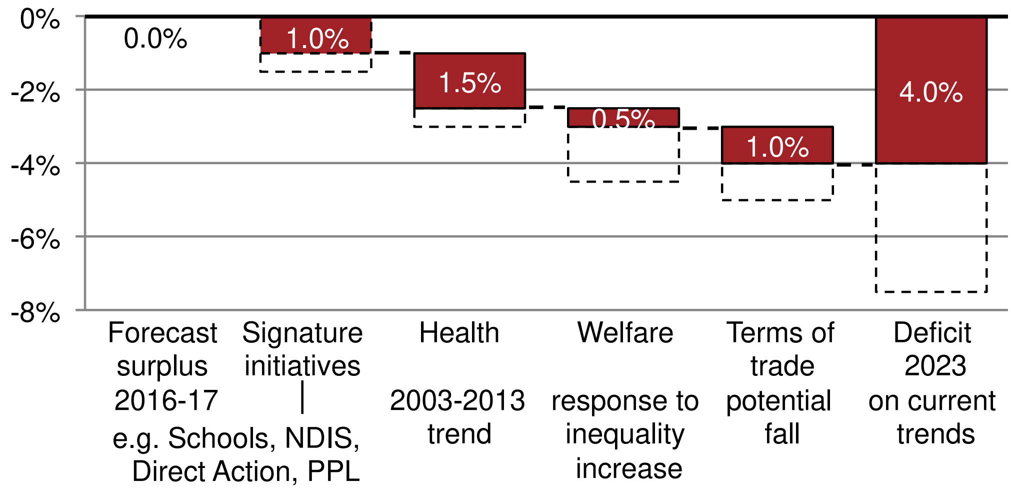
[7] Kohler, "family Biz: Full frontal innovation" *Business Spectator* 18 April 2013, http://www.businessspectator.com.au/article/2013/4/18/family-business/family-biz-full-frontal-innovation

[8] Business Council of Australia, *Action plan for Australian prosperity: full report* (2013), p.87 http://www.bca.com.au/publications/action-plan-for-enduring-prosperity-full-report

[9] *Budget pressures*, p.44

[10] See *Budget pressures*

Potential annual deficit of Australian governments' budgets by 2023
(Percent of GDP)



Grattan Institute, *Budget Pressures on Australian governments*; Grattan analysis of subsequent budget papers

2.4 Why do we care?

Does any of this matter? If Australian budgets are a bit overweight – like many Australian people – can't we just take a few cholesterol lowering drugs and carry on? Relative to some severely obese European countries, surely we have little to worry about?

It is true that Australian governments owe much less than many governments elsewhere. We are not in the emergency ward, crawling from one debt reconstruction to the next, with government slashing the social safety net, and the economy shrinking. But surely the lesson we want to take away from countries that do look like this is that we do not want to go there.

The most important argument for budget reform is that government debt effectively requires future generations to pay for the spending of the current generation. In most recent times, the run up in Queensland government spending led to annual interest payments of over $1.5 billion per year, substantially constraining the State budget.

Relatively little of the *increase* in annual spending will benefit future generations by increasing future economic growth. While health spending increases participation a little, its major effect is to help people live longer and happier retirements. This is absolutely a good thing, but should future generations pay for it?

3 REFORMING OUR LIFESTYLE

3.1 Current promises

Australian governments are promising to do better. But a doctor would be worried that the patient will not actually change. The last Commonwealth budget planned real cost growth of 4.3% for 2013-14, but promised on behalf of the next government that real spending growth in the following three years would only be 1.8%.[11]

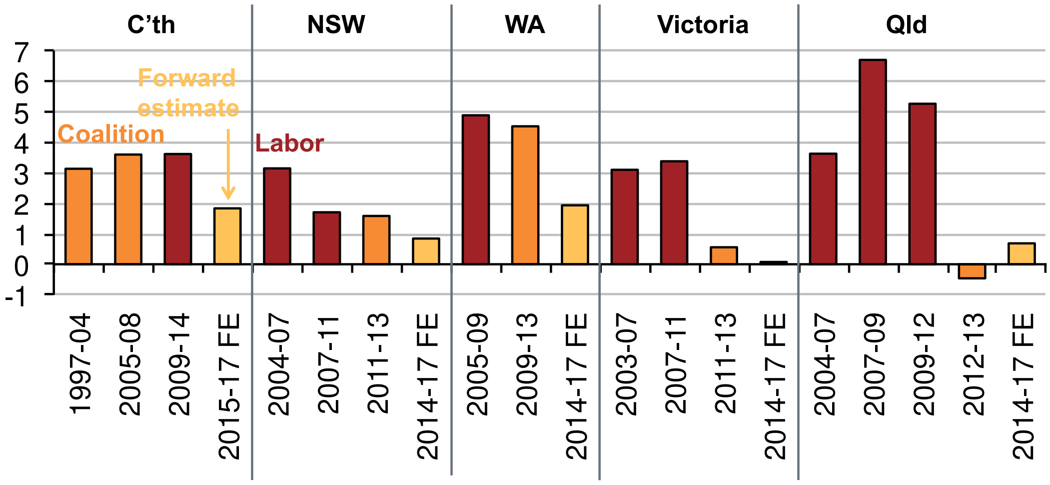
To hit this target the Abbott government will need to be much more frugal than its predecessors. From its starting point before the global financial crisis to the budget of 2013-14 (by which time the stimulus spending should have been well washed out of

[11] Commonwealth Budget 2013-14, *Budget Paper No.1*, p.10-6

the budget), cumulative spending growth under the Rudd-Gillard governments was 3.7% per year.[12] The Howard government averaged 3.2% in its first three terms, and 3.6% in its final term. 1.8% for three years is a big ask.

There is no guarantee that a new Coalition Commonwealth government will be so much better. While new coalition governments in Victorian and Queensland have substantially reformed their budgets, Coalition governments with big majorities in both NSW and WA have not cut spending much.

Real expenditure growth by state government term,
cumulative annual growth, % p.a.



Source: Grattan analysis of Commonwealth and state budget papers.

3.2 Denial

There are worrying signs that the patient has gone into denial. In recent months both sides of politics have downplayed the urgency of Australia's budget issues. Perhaps chastened by the experience of the last government, the new Commonwealth government has not (yet) committed to a date by when the budget will return to surplus.

The prospects of slower economic growth and rising unemployment have led some to urge a return to Keynesian stimulus. There *are* some clouds on the economic horizon. GDP growth has slowed to 2.5%.[13] Unemployment has increased from 5.1% in April 2012 to 5.8% in August 2013.[14]

However, we should worry about a tendency to look for any excuse to put off eating better and exercising more until *next* year. There will always be reasons to put off the hard political work of actual budget repair.

Around the world, governments are keen to promise budgetary virtue, but less keen to deliver it. Budget choices are hard. No-one likes paying higher taxes or receiving fewer services. No-one likes any short-run reduction in economic growth. The benefits of lower interest payments are inevitably promises about the future that people tend to value less.[15]

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[12] Commonwealth Budget 2013-14, *Budget Paper No. 1*, p.10-6

[13] ABS, "Australian National Accounts: National income, expenditure and product, June 2013" Cat. 5206.0

[14] ABS (2013), "Labour force, Australia" Cat 6202.0, Table 1.

[15] Kahneman, *Thinking fast and slow* (2012); Buchanan J and Wagner R (1977) *Democracy in Deficit: The Political Legacy of Lord Keynes*, Academic Press

That's why Australia's historic aversion to government debt[16] may not always be the economically first best answer, but from a political economy perspective, it's a very good second best. Unless governments are under constant electoral pressure to avoid debt, they will tend to find reasons to spend tomorrow's tax dollars today, until they hit the hard limits of financial market tolerance, and borrowing becomes either high cost or impossible. Reaching *those* limits is clearly a third best outcome.

In any case, the current situation may be as good as it gets for some time. GDP is still 2.5%. This may well be the long-term growth rate for many years. Some economists such as Tyler Cowen[17] and Stephen King (from HSBC)[18] are suggesting economic growth will be slower in developed countries for the next few decades given there is no obvious wave of productivity enhancing platforms, and ageing is starting to reduce participation rates.

Similarly, while unemployment is 5.8% – high relative to the last decade of the mining boom – it is much less than the 7.7% average of the previous decade.[19] And these economic results were achieved after a year in which the Commonwealth government reduced its spending by $3.8 billion in *nominal* terms[20] – even if that statistic is much helped by payment shuffling between years. And Keynesian theory advocates spending in the bottom half of the economic cycle, but saving in the top half. It may well be that we are in fact in the top half of the outcomes that we can expect for the foreseeable future.

And we have an insurance policy. If budget repair results in a significant increase in unemployment, then Australia's central bank, unlike its counterparts in most of the developed world, still has substantial room to cut interest rates further to stimulate the economy.

4 WHAT SHOULD WE DO?

4.1 Substantive solutions

So what should we do?

We may need some different solutions to those of our recent past. Budget reforms in living memory had to make hard decisions about recurrent spending to bring budgets back into balance. But they eliminated the backlog of debt largely by selling assets. The Howard Government reduced debt by $58b between 1997 and 2002, and sold around $40 billion of assets, including Telstra, the Commonwealth Bank, and several airports. Between 1992 and 2000, the Kennett Government in Victoria reduced debt by $37 billion, and sold around $45 billion of assets, particularly its electricity and gas companies. It is not obvious that the Commonwealth Government has many sellable assets worth this kind of money today.

Looking further afield, governments elsewhere have dug themselves out of much larger deficit positions by making tough decisions. A recent International Monetary Fund survey of budget repair found that the major driver of success was the hard work of decisions that improved the structural budget balance, on average by around 3% of

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[16] Macfarlane, I.J. (2006) "Economic news: do we get too much of it?" 28 April 2006, accessed January 2013 from http://www.rba.gov.au/speeches/2006/sp-gov-280406.html

[17] Cowen, T., *The great stagnation* (2011), Dutton Adult

[18] King, S., "When wealth disappears", *New York Times*, 6 October 2013

[19] ABS (2013), "Labour force, Australia" Cat 6202.0, Table 1; Grattan calculations

[20] Commonwealth Treasury, *Final budget outcome 2012-13* (2013), p.2 http://www.budget.gov.au/2012-13/content/fbo/download/2012-13_FBO_Consolidated.pdf

GDP.[21] Just as sustained deficits can rapidly lead to large debt positions, sustained surpluses can erode even large debts in a decade.

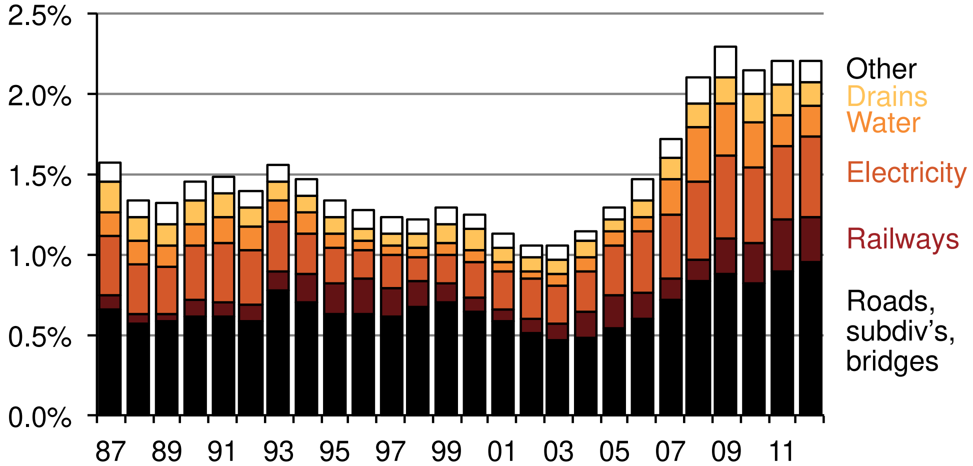
4.2 What won't work

The same IMF paper found that most of these countries did *not* solve their debt and deficit issues simply by "growing out of trouble". More structural reform is required.

Along similar lines, some hope that more short-term spending in infrastructure will lead to longer term economic growth that will help the budget bottom line, or at least increase the denominator of the debt to GDP ratio.

If so, our infrastructure spending will need to do much better than the last five years. Just looking at roads and railways, government spending on constructing infrastructure is a larger percentage of GDP than at any time since the ABS started collecting records in 1987. It is not obvious that this five-year surge in infrastructure spending has been matched by a surge in productivity.[22]

Engineering construction work done – for public sector
% of GDP, calendar year



Source: ABS, *Engineering Construction Activity, Australia* Cat no 8762 Table 11. Excludes telecommunications which is insignificant after Telstra sale

This may surprise those who have heard that Australia has an enormous "infrastructure deficit" sometimes estimated at $800 billion, holding back economic growth.[23]

This infrastructure deficit may be more engineering mirage than economic reality. The only published evidence of a large "infrastructure deficit" appears to be a long wish-list of the projects that engineering and construction firms would like to build. The Alice Springs to Darwin railroad stands as a monument showing that some infrastructure costs more than the economic growth it produces. Infrastructure only increases productivity if it is the right infrastructure in the right place, provided at the right price.[24]

Nor is there any magic in the private sector taking infrastructure spending off the government's balance sheet. Often these schemes are merely an exotic (and usually expensive) investment banking structure in which governments ultimately promise to

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[21] Abbas, S.A., Akitoby, B., Andritzky, J., Berger, H., Komatsuzaki, T., and Tyson, J, " Dealing with high debt in an era of low growth" (2013), IMF staff discussion note, http://www.imf.org/external/pubs/ft/sdn/2013/sdn1307.pdf

[22] *Game-changers*, p.27

[23] Engineers Australia (2010) *Australian Infrastructure Report Card 2010.* (2010)

[24] *Game-changers*, p.26

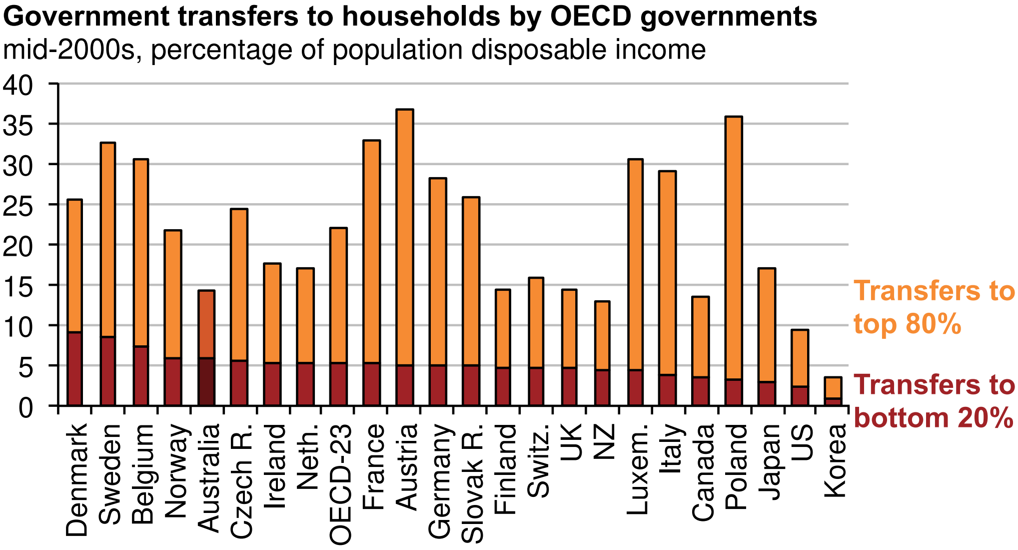
pay away future tax revenues. Things are different if the loan is to be repaid only from additional infrastructure-linked revenue such as tolls – but given the experience of tollroads from Clem 7 to the Lane Cove Tunnel, this is the precise risk that the private sector is now very reluctant to take.

4.3 What won't make much difference

The search for savings is not going to be easy. The Rudd-Gillard governments have squeezed the public service for easier wins through a series of efficiency dividends. Middle class welfare has been quietly constrained as benefits were retargeted towards genuinely poorer families.

Indeed, despite the common perception that Australia has vast swathes of middle-class welfare, it's hard to find recipients under the age of 60. Family Tax Benefit A, the Schoolkids bonus and the baby bonus are now all targeted at less wealthy families.[25] Family Tax Benefit B is more generous, but only about $0.5 billion goes to families not eligible for Family Tax Benefit A.[26]

As Peter Whiteford has demonstrated, Australia in fact has the most tightly targeted welfare system in the world: we are relatively generous in providing transfer payments to those in the bottom 20%, and extremely frugal in providing few payments to people in the top 80%.[27]



Source: Grattan analysis of Whiteford (2010)

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[25] Family Tax Benefit A starts to reduce when family income is above $49,000 per year, and for a family with two children cuts out entirely at around $108,000 per year. The Schoolkids Bonus (which the current government has committed to abolishing: Hockey and Robb , 'Final update on federal Coalition election policy commitments', L. P. o. Australia, 5 September 2013, accessed October 2013, from http://www.liberal.org.au/latest-news/2013/09/05/final-update-federal-coalition-election-policy-commitments) will only cost $1.3 billion in 2013-14 (FaHCSIA, *Portfolio Budget Statements 2013-14: Families, Housing, Community Services and Indigenous Affairs Portfolio* (2013), Department of Families, Housing, Community Services and Indigenous Affairs, accessed October 2013, from http://www.dss.gov.au/sites/default/files/documents/05_2013/fahcsia_portfolio_budget_statements_2013-14.pdf). The Baby Bonus will cost $0.4bn in 2013-14: both are now only paid to families eligible for Family Tax Benefit A.

[26] Unpublished NATSEM modelling, cited in Karvelas, P., 'Family tax ripe for budget axe, NATSEM modelling finds', *The Australian,* 28 February 2013, accessed August 2013, from http://www.theaustralian.com.au/national-affairs/policy/family-tax-ripe-for-budget-axe-natsem-modelling-finds/story-fn59nsif-1226587257174

[27] Whiteford, *Australia: Inequality and prospecrity and impacts in a radical welfare state* (2013), Social Policy Action Research Centre, Crawford School of Public Policy, ANU, accessed October 2013, from https://crawford.anu.edu.au/public_policy_community/content/doc/Australia_Inequality-and-Prosperity_final-15-March-13.pdf

Similarly, the Australian health system is already one of the most efficient in the world. We spend around the average per capita in the OECD, but have higher life expectancy than most.[28] Substantial reductions in health expenditure will require Australia to invent new solutions, and this is unlikely to happen quickly.

Nor are there likely to be major savings in slashing Commonwealth departments. Staffing the Commonwealth health department, for example, only costs $600m per year. These staff may not run any hospitals, but they are ultimately responsible for the Medicare and pharmaceutical benefits systems that pay out close to $30 billion per year, so presumably someone in the Commonwealth needs to look after them.

4.4 Tough choices.

So what are our choices?

We can spend less on health, by not providing all the services that are available today. We can look at untouchables like superannuation payments. We can talk about increasing taxes. None of these options is going to be wildly popular. But the choices aren't going to get easier. One of the few choices that both increases economic growth in the medium term *and* helps the budget position is to increase the age at which people can access the age pension or their superannuation. This reform will not close a budget deficit of 4% of GDP by itself, but it would make a substantial difference in time.

The acid test will be whether Treasurer Hockey's first budget contains substantial net improvements to the structural budget balance. There are few governments that improved their budgets much after several years of avoiding hard decisions. To build political momenturm for difficult decisions, governments need to admit loudly, repeatedly, and in public, that they have a serious problem, and everyone needs to bear the burden of the difficult decisions. Otherwise it is all but impossible to build credibility later on for politically difficult decisions.

In conclusion, Australian government budgets are not blue on the operating theatre table. But they are in serious trouble, all the warning signs are there, and as yet there are few signs that governments are serious about reforming their behaviour. In a sense, budgetary reform is never urgent – putting it off another year only adds a little bit to the waistline. But the cumulative effect of putting off the difficult decisions is to make the risks greater every year, and the ultimate and inevitable task of regaining fitness ever tougher. In the sense that there is a compelling case for immediate action, but the patient is yet to get serious about the hard work of reform, we still have a budget emergency.

[28] *Game-changers: supporting materials* p.51