The Australian Budget – some context

Speech to the Sydney Institute, 28 January 2016

What I want to do tonight is rather simple – outline some of the background to the current budgetary situation and some of the issues that confront the Government.

It's a dry but important subject.

No Budget ever satisfies everybody.

The world, and Australia, are not short of people who have become Budget experts. There will always be a wide range of views as to the appropriate budget settings. There is no shortage of people who feel that they have been harshly treated in any Budget. And now and again, there are even some who are satisfied.

Framing budgets is difficult and has always been so. The main difference now, compared with my experience in the 1970s, 1980s and early 1990s, is that everything seems far more complex.

There is always the challenge of the immediate budget year and now increasingly, we need to frame a Budget over the four years of the forward estimates. If anything, the forward estimates now seem to be a little more important. And that is probably a good thing as we are more sensitive to consequences beyond the immediate year. But it can also foster a little complacency about the immediate challenge.

Beyond the immediate Budget year and the forward estimates, we must now be more mindful of the longer term pressures on government spending from population

trends and, in particular, the ageing of the population and the associated rapidly growing pressures on health funding.

Over the years, forecasting the budget aggregates has also become more difficult.

This is because of continued uncertainty surrounding the forecasts that underpin the Budget. We are now a far more integrated part of the global economy – and far more at the mercy of international financial and economic pressures.

Unexpected movements in domestic and global factors that drive Australia's economic growth and the economic outlook, including greater than anticipated movements in commodity prices and a number of broader political factors, have meant that in every Budget update since 2014, the fiscal outlook has been downgraded.

Each time, we've had projections of larger deficits and higher debt levels.

The Mid-Year Economic and Fiscal Outlook (MYEFO) released late last year revised down the Treasury's estimate of Australia's current and future potential GDP. That revision also implied a greater share of the current and prospective budget short-falls stemmed from structural rather than cyclical factors.

The clear message is that we cannot rely on any cyclical bounce to reduce outlays as a percentage of GDP or, for that matter, the deficit.

We are not in a crisis. But the Budget is rightly a focus of attention.

That said, Australia has a strong fiscal position by international standards. Indeed, many countries would like to be in our position.

But we have a structural budget problem that arose before the global financial crisis. The recent weakness in revenue is only partly to blame. From the outset of the commodity price boom of the early 2000s, Government revenue grew faster than expected as the terms of trade persistently exceeded expectations.

But structural expenditure decisions offset much of the temporary revenue gain. In particular, a very substantial amount was spent on ongoing programs that increased transfer payments and benefits.

In simple terms, and as I said in my speech to CEDA in February last year, some of the proceeds of our once-in-a-generation commodity price boom were used to pay down debt and set against future liabilities through the creation of the Future Fund.

Changes to the personal income tax scales over this period also helped to relieve pressure on households and reward personal effort and initiative.

In addition, the work of fiscal repair during the late 1990s and early to mid 2000s provided an important buffer for when the global economy was hit by the GFC.

But a very substantial amount of the revenue windfall was used to lock-in long-term spending commitments.

Since then, the rate of Government spending growth has remained high despite considerable savings measures over more recent years.

At first, this could be attributed to GFC-related fiscal stimulus.

But as temporary stimulus measures were unwound, growth in spending continued apace. This in part reflected a number of ongoing welfare and other spending

programs that were put in place in response to the GFC but largely became a permanent fixture.

In real terms, spending has grown at an annual average rate of around 3.5 per cent since 2007 compared with around 3 per cent during the 1980s and 1990s.

As a result, at 25.9 per cent of GDP, spending in 2015-16 is forecast to be close to the post-GFC peak, and could have been higher were it not for the measures taken by the Government in MYEFO.

More recent savings measures are helping. The payments-to-GDP ratio will now decline over the budget forward estimates to 25.3 per cent by 2018-19. But spending will not get below 25 per cent at any time over the next decade.

Some of the key drivers of this change have been in critical programs like aged care, disability care and help for the unemployed and sick.[1]

Commonwealth interest payments have also risen sharply[2], contributing to the overall rise in the payments-to-GDP ratio and this is despite a period of remarkably low borrowing costs.

In recent years, falling global commodity prices, combined with more moderate wage and price growth domestically, have seen Australia's nominal GDP growing at 50-year lows. And while real GDP growth rates have remained respectable in the face of difficult global circumstances, it's nominal GDP that matters for revenue.

---

[1] From 2007-08 to 2015-16 as a percentage of GDP, aged care increased 0.6 percentage points; disability care increased by 0.5 percentage points; and help for the unemployed and sick increased by 0.3 percentage points.

[2] By around 0.6 per cent of GDP (from 2007-08 to 2015-16).

Indeed, much of the deterioration in the budget position has been the result of revenue collections falling short of forecasts as we experience the flipside of the mining investment boom.

Further, Treasury's recent reassessment of the assumptions behind our medium-term growth projections resulted in the estimated potential output growth rate being lowered from 3 per cent to 2¾ per cent. These changes are crucial for the real GDP outlook for the final two years of the forward estimates – that is, 2017-18 and 2018-19 – which has been revised down from 3½ to 3 per cent.

The nominal GDP and therefore the revenue projections for these years are now lower and more realistic.

There are no 'right' answers when it comes to producing growth projections, as these figures are sensitive to the assumptions that underpin them.

For those lower projections in the third and fourth year in the forward estimates, we used the same projection framework, which is considered best practice internationally. Similar approaches are also used by the Congressional Budget Office in the United States and the UK Office for Budget Responsibility.

We haven't changed the way that we forecast the first two years of the forward estimates, which uses a more granular approach to forecasting, taking account of particular sectoral trends in areas like the housing market and exports. While this sectoral approach is very useful for forecasting the economy over the near term, it is not so useful over longer horizons when aggregate factors on the supply-side tend to play a larger role in shaping economic growth.

Our approach to international forecasts is comparable to other organisations and also utilises intelligence from Treasury's international posts.

The historically low nominal growth outcomes and lower growth projections, alongside historically high payments-to-GDP, mean that it's taking longer for the budget position to return to pre-crisis levels compared with the cyclical downturns of the early 1980s and 1990s.

This brings me to observations on our current fiscal position.

The Government's medium-term fiscal strategy includes achieving budget surpluses, on average, over the course of the economic cycle. This will take time.

Expenditure restraint will allow resources that would otherwise go to interest payments to be allocated to other priorities, like reforms to the tax system and Commonwealth State financial relations.

Further, in the longer term, the Commonwealth achieving surpluses means that the States can run small overall deficits that they can use to finance productive infrastructure investment. This was a key conclusion of the 1993 National Savings Report commissioned by the then Treasurer, John Dawkins. In my view, this is still a sound framework for thinking about fiscal policy today.

The rising structural deficits and debt give rise to intergenerational issues.

Why should the living standards of future generations be compromised just because we were not willing to make sacrifices to address the unsustainable growth of government expenditure?

In December, the MYEFO showed that the Budget is projected to return to a small surplus in the early 2020s.

These surpluses are projected to peak at only 0.4 per cent of GDP and then decline over the medium term.

Budget repair has proved difficult in recent years for a range of reasons.

This can be demonstrated by looking at how our estimates for the 2016-17 year have evolved over time.

At the 2013 Pre-Election Economic and Fiscal Outlook (PEFO) in August 2013, we expected there to be a surplus of 0.2 per cent of GDP in the 2016-17 year.

Since then, the expected underlying cash balance has deteriorated by some $37.9 billion, with the most recent estimate being a deficit of 2.0 per cent of GDP for 2016-17.

Of course, successive downgrades to tax receipts have been the main driver of this deterioration. In total, we now expect to receive around $39 billion less in tax receipts in 2016-17 than we did at the time of the 2013 PEFO.

Income tax receipts are being weighed down by lower than expected working-age population growth and weaker wages growth, as well as declines in commodity prices and weaker equity markets.

The impacts of successive revenue downgrades have only been partially offset by the Government’s structural saving measures.

Around $14 billion of these measures are yet to pass the Senate. Further delays will have a negative impact on the fiscal outlook.

At the same time, some of the measures that successfully passed were amended in Senate negotiations.

Importantly, further savings of $8 billion were announced at MYEFO.

The Commonwealth's gross debt is projected to reach 29 per cent of GDP by June 2018. Even during the volatile 1980s and 90s, debt did not reach such heights, peaking at around 24 per cent.

Net debt is approaching levels not seen since the early 1990s recession, which at that time was the highest since World War 2. We are yet to return to pre-GFC net debt levels.[3]

Around two-thirds of Commonwealth public debt is held by non-resident investors. This share has risen since 2009 and remains historically high.

This, if anything, leaves Australia's fiscal position a little more exposed to shocks in global capital markets.

The Commonwealth's interest bill has reached over a billion dollars a month. This is projected to more than double within the decade, unless action is taken to improve our budgetary position.

[3] Commonwealth Government net debt has increased from negative 4 per cent of GDP (that is, a net asset position) in 2007-08 to positive 15 per cent of GDP in 2014-15 and is projected to rise to a peak of 18.5 per cent in 2017-18.

Importantly, although debt-servicing costs as a proportion of GDP are around half what they were in the mid-1990s, government debt is currently being serviced at historically low interest rates.

At MYEFO in December, borrowing costs were estimated at just under 3 per cent, compared to the cost of around 8.5 per cent 20 years ago.

The debt burden and servicing costs are growing with each budget deficit and will grow even faster when global bond yields inevitably normalise. If the bond rate were to return to its long term average of about 7.25 per cent[4], the Government's debt servicing costs would increase by over $29 billion over the forward estimates (2015-16 to 2018-19).

It's important that Australia maintain its top credit ratings, which helps to contain the costs associated with servicing public debt.

Australia is one of only ten countries with a triple A credit rating from all three of the major rating agencies, reflecting our reputation for fiscal prudence.

But this rating is dependent on credible fiscal consolidation and a smooth transition to a more diverse economy.

We should not be complacent about this. I know from personal experience during the financial crisis how important a strong credit rating is to investor confidence.

If we are to permanently reduce net debt, we are going to need to achieve sustained 'structural' budget improvements.

[4] RBA Table F2: Capital Market Yields – Government Bonds. 10 year CGS bonds, 30 year monthly straight average.

It can be difficult to separate accurately which elements of the budget should be considered structural and which cyclical; the many measures that attempt to do so all have their limitations.

Treasury assesses the long-term position of the budget by estimating the so-called "structural budget balance".

But in essence, the "structual budget balance" is an estimate of what the budget position would be in the absence of cyclical or temporary factors. For example, cyclically high unemployment raises government expenditure via higher unemployment benefits and lowers government revenue via lower labour income tax receipts.

With the exception of unemployment benefits, government expenditure is assumed to be structural.

MYEFO showed a structural budget deficit of around 1¾ per cent of GDP in 2015-16 compared with an underlying cash deficit of around 2¼ per cent of GDP. So based on these estimates, only around $9.9 billion of the $37.4 billion deficit is considered to be due to the weak cyclical state of the economy.

Treasury's estimates of the structural budget deficit have successively worsened over the past several years, in line with downgrades to the underlying cash balance.

Our immediate priority is to repair the fiscal position –both structural and otherwise.

There are no hard and fast rules on fiscal repair – and there are many factors to consider.

There were determined efforts to cut spending in the 1980s and also in the late 1990s.

These were characterised by: limiting new spending and/or fully offsetting net new policy with savings from the same porfolios; better targeting of transfer payments; and changes to payments to the states.

Going forward, the more we can do to limit net new policy spending, the better. This includes reprioritisation of spending within portfolios.

For the longer-term, we need to look for substantial structural savings across the board - including transfer payments.

The Government has had some recent success in passing measures for expenditure restraint, which are expected to limit the growth of welfare payments over coming years.

Generally speaking, our welfare spending is highly targeted and redistributive. After taking into account the low level of tax paid by those on lower incomes, Australia redistributes more to the poorest 20 per cent of the population than any other OECD country except Denmark.

As a side note, the OECD recently reported that Australia spent well below the OECD average on pensions. But when other forms of assistance are included, such as non-cash benefits – for example, subsidised health care, and superannuation tax concessions – Australia compares more favourably.

Australia's retirement income system also ranks favourably compared with other countries, taking into account the Age Pension, household savings and homeownership. The Melbourne Mercer Global Pension Index ranked Australia 3rd out of 25 countries overall and 1st for adequacy.

At MYEFO, total Commonwealth payments as a proportion of economic output were estimated at 25.9 per cent in 2015-16.

There have only been four other periods since 1970 when this ratio has exceeded 25 per cent. Three of these are associated with economic recession and deficit blowouts – during the early 1980s and the 1990s, and of course just after the GFC.

Part of the increase in the ratio has been the result of weaker than expected nominal GDP growth - meaning that even if Government payments remained at their nominal level the ratio would tend to increase.

But there have also been a number of policy decisions over recent years that have pushed the ratio higher: including increasing base pensions and supplementary payments, increased Defence operations and border protection spending, expenditure related to the carbon compensation package and the outcomes of negotiations around the repeal of the Minerals Resource Rent Tax.

And the Government continues to face spending pressures.

Within the current budget estimates, there are a number of programs whose spending is expected to ramp up in coming years, including spending associated with the NDIS.

If payments stay too high and at 25 per cent of GDP or more, receipts will need to be increased very substantially to balance the Budget.

Simply increasing the overall tax burden to raise more revenue is not the answer. It runs the real risk of distorting economic incentives and lowering international competitiveness with negative impacts on investment, growth and job creation.

Of course, it is always a matter of judgment – but seeking to keep spending below 25 per cent of GDP may be a useful marker.

This would mean that we would seek to avoid having spending reach or exceed the levels met in periods of especially adverse circumstances in the past few decades.

The fact is that there are seldom easy choices when expenditure savings are required.

There are many worthwhile spending programs and, every year, there are more good ideas than government resources to support them.

There is also often, a mismatch between what the community expects the government to support and what they are prepared to pay for either in tax or in user charges.

In framing budgets, we are really asking ourselves now and in the longer term what sort of society we want to have.

As I have said many times before, as a wealthy country, we have a responsibility to support the most disadvantaged in our community.

And we can only do so by having a strong and sustainable fiscal position.

Laying out a path of sensible and credible fiscal repair — along with a plan for structural reforms that address our long-term growth challenges — will provide the building blocks for long-term fiscal sustainability and strong and stable economic growth.

Faced with the same difficult choices that Australia now faces, many developed countries have managed to undertake significant budget repair in a relatively short time. While at the same time, they have seen economic growth prosper.

For example, the US budget deficit has been reduced by 9.3 per cent of GDP since it's peak in 2009 to a deficit of 3.8 per cent of GDP (although I note that this has only been partly policy-driven – blocks to spending proposals in Congress have also assisted). The US economy has been growing since 2010, and GDP is now almost ten per cent higher than prior to the GFC.

The UK has reduced their budget deficit by 6.6 per cent of GDP since the peak in 2009. The UK economy has been growing since 2010 and GDP is now around 6 per cent higher than prior to the GFC.

Ireland managed to record the greatest improvement, reducing their deficit from 32 per cent of GDP to 2 per cent over 5 years. Ireland's GDP growth was 6.8 per cent through the year to September and has been growing strongly since the middle of 2013. Ireland's GDP is now more than seven per cent higher than prior to the GFC.

Australia's Budget position never was as bad as these countries and our economy never stopped growing. But we cannot be complacent.

Expenditure restraint played a key role in all these countries in improving their fiscal situation.

All that said, over the longer-term, economic growth will be critical for fiscal sustainability as well as continued improvements in living standards. This will require ongoing productivity-enhancing structural reform.

The 2015 Intergenerational Report highlighted the long-term challenges that lie before us.

The ageing of Australia's population will weigh heavily on Australia's potential growth rate and long-term fiscal position. Demographic and broader medium-term pressures will place greater demands on government finances, making deficit and debt reduction more difficult.

Structural reform is critical and this includes reforming competition policy and implementing the Harper Review recomendations.

Improving productivity is a far more sustainable way to boost economic growth than relying unduly on an exchange rate depreciation.

These growth-enhancing policies also very much include tax reform. Tax is not just about raising revenue, it is also about helping to shape the economy so that we attract and deploy resources in a manner to promote long term growth. The arguments for a tax mix switch rest heavily on encouraging more jobs through a higher growth path. Tax reform is a complex issue and is very much the focus of the Government at the current time.

Concluding remarks

We are a rich country in so many ways and we can look forward to sustained economic growth if we have the right attitude and policies.

A stronger long term fiscal position will go hand-in-hand with other policies to lift our growth and living standards.

Thank you for your time this evening.