Market Economics

OPENING REMARKS TO THE SENATE SELECT COMMITTEE INTO THE ABBOTT GOVERNMENT'S COMMISSION OF AUDIT

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Australia does not have a government debt or deficit problem.

According to Treasury numbers published by Treasurer Mr Hockey in the Mid-Year Economic and Fiscal Outlook in December, over the last 43 years of budget outcomes (the full data set), there have been 19 budget surpluses and 24 budget deficits.

Up until 2007-08, just prior to the collapse of the global financial system and the onset of the deepest recession in the industrialised world since the 1930s Great Depression, surpluses were a little ahead of deficits, 19 to 18. This suggests that the recent move to budget deficit is almost certainly nothing more than the long-run business cycle impacting of government finances.

With the financial crisis slowly but surely passing and the global economy now on a track to record a sustained expansion, there seems little doubt that the mix between surpluses and deficits in Australia will again equal out as we participate in this expansion phase and revenue starts to flow back to the government.

And this is how it should be.

Reinforcing the strength of public finances in Australia at the moment, Treasury data published in MYEFO shows that the level of net government debt stands at 10.0 per cent of GDP, a miniscule level. For the OECD, the average is over 100 per cent of GDP.

By way of background, net government debt was a little below zero before the collapse of the global financial system hit Australia, but those same Treasury documents presented by Mr Hockey show that since the early 1970s, the level of net government debt has never been above 18.1 per cent of GDP and the average level of debt over that long time frame approximately 7 per cent of GDP, a little below the level now.

This is remarkable and shows just how prudently government finances have, on average, been managed for over 40 years.

For Australia, with the economy clearly entering a phase of stronger growth, it is prudent to move the budget back to surplus. This is a relatively straight-forward task given the solid pace of economic growth unfolding and what we are likely to see in terms of some moderate tightening in fiscal policy in this year's budget.

An unwinding of the government's shifting of payments, in particular the outlay of $8.8 billion to the Reserve Bank of Australia, will also help to see the budget return to surplus in the next few years.

It is somewhat alarming to see the increasingly popular view that budget deficits are bad and surpluses are good. Alarming because it may encourage policy makers to take the wrong decisions when managing fiscal settings without paying attention to the business cycle. There was a risk of this with the previous government with its commitment to return to budget surplus in 2012-13. It was a worthy objective but thankfully it did not stick to that strategy when it became apparent that the decline in the terms of trade and high value for the Australian dollar had impacted negatively on national income growth and therefore government revenue.

Had it cut spending to meet its surplus goal, the economy would have weakened appreciably and the unemployment rate would inevitably be higher than it is now.

The government and the economics profession needs to work hard to change the misconception that surpluses are always good and deficits always bad.

There should be no value judgement that suggests budget deficits are good or bad without context being placed around the economic and fiscal position.

I have used the analogy elsewhere, but I think it makes the point – is a warm and sunny day good or bad?

Most obviously, it depends.

For a holiday maker at the beach, a warm sunny day is clearly good. But for a farmer on marginal land in the midst of a drought, another warm and sunny day is clearly bad.

A similar judgment should be applied to budget deficits and surpluses.

It would be an economic policy failure, in the extreme, for any government to be aiming to run a budget surplus if the economy was in recession and the unemployment rate was rising. Here a budget surplus is unquestionably bad, while a deficit would be good, even if it was merely the result of the government allowing the automatic stabilisers on revenue and expenditure to kick in.

Similarly, if the economy was in a well established period of above trend growth, with very low unemployment and inflation pressures evident, a budget surplus would be good and a deficit bad.

When I look at the business cycle in Australia over the last four decades, I see quite clearly that this approach has been in place, more or less, from both sides of politics. I note the Howard government running a budget deficit in 2001-02 as the economy slowed markedly, if only temporarily, in the wake of the 'tech wreck' in the US and aftermath of the terrorist attacks on the US in September 2001.

This was appropriate.

Perhaps the best assessment of the state of public finances in Australia is given from the international credit rating agencies.

All three major agencies, Standard & Poors, Moodys and Fitch assess Australia as a triple-A risk with a stable outlook. They held this assessment even after seeing the seemingly pessimistic view presented in MYEFO. Indeed, Fitch upgraded the rating of Australia to triple-A late in 2011 after it observed the prudent use of fiscal deficits to maintain economic growth and to cap the unemployment rate.

In closing, I also note that Australia is in its 23rd year of continuous economic growth, a quite remarkable achievement. In addition, it has been more than 10 years since Australia's unemployment rate was above 6 per cent and over the past 20 years, inflation has averaged 2.5 per cent.

These are stunning economic achievements.

While there are many reasons for this remarkable trifecta of economic achievement, sound fiscal policy settings would rank highly among them.

Going into budget deficit when needed, staying in deficit when needed, returning to surplus when needed and holding on to surpluses when needed are all part of the policy framework that has helped make Australia one of the richest countries in the world.

Only the economically ignorant would hanker for a budget surplus on all occasions. No credible economist I am aware of would advocate unending surpluses and no government debt in perpetuity. Nor would they argue for a budget deficit on all occasions with forever rising level of debt.

It is not that complex, even though, as we have seen, surpluses or deficits can persist for many years.

These economic achievements over many years have helped propel Australia to the fifth richest nation in per capita GDP terms, according to the International Monetary Fund, behind only Luxembourg, Qatar, Norway and Switzerland.

While the role of government is to prioritise spending and revenue raising measures, and here the Commission of Audit will have some valuable input into the government's deliberations, account of the business cycle is fundamental when considering how much needs to be cut or which taxes need to be raised.

If the pace of economic growth were to remain below trend into 2014 and 2015, perhaps as the terms of trade decline and mining investment falls, an austere budget that returns to surplus in a hurry would be inappropriate policy. It would unambiguously add to unemployment and compound the economic downturn.

Based on the current Treasury projections, the scope for a significant fiscal tightening is limited.

If, as appears more likely, the economy is stronger than the MYEFO forecasts, the scope to trim a little more and lock in the return to surplus would be prudent.

Thank you.