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Australia's financial management challenges post-COVID

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Abstract

COVID ended Australia's almost three decades of GDP growth and generally sound budget management at the federal level, from the early 1990s to the end of 2019. Australia's federal public financial management performance had been applauded by international institutions over this period. That economic policy 'exceptionalism' over many years provided the necessary buffer to use overwhelming fiscal and monetary firepower initially in 2020, before more prudently calibrating the policy response towards the end of 2020 and in 2021. This chapter describes Australia's fiscal response during COVID and considers the economic and budgetary challenges Australia now faces, and how we might deal with those challenges over the rest of this decade and beyond. We find that, while one can argue about individual components of the COVID stimulus package, the overall approach of compensating for the temporary costs and hardships of government decisions was entirely sensible. While the outlook for Australia's public finances is positive, there are a number of caveats to this conclusion, including risks around slower productivity growth, structural increases in public expenditures related to ageing and disability, a preference for the 'mega project' among the political class, and rising interest rates.

Keywords: fiscal policy; fiscal stimulus; public financial management; COVID; ageing; public infrastructure investment.

Introduction

Only time will tell to what extent the global COVID pandemic has broken Australian society, but there is no doubt that, at least temporarily, COVID broke the Australian economy.[1] The Australian federation's public policy response to COVID included shutting the international border to overseas tourists, business travellers and students, and closing many 'non-essential' domestic industries such as interstate tourism, non-grocery retail shopping, schools and universities, sporting and music events and gyms. Fortunately, Australia's resources and bulk commodity export ports continued to operate, sending iron ore, coal, natural gas, gold and livestock to the rest of the world.

Despite an immediate fiscal expansion (and concomitant monetary loosening) designed to offset an expected employment deep freeze or outright permanent job losses, the end result was a V-shaped recession in quarterly terms in mid-2020 and a sharp rise in the household savings rate as substantial transfer payments were made to households, and as families, especially in Melbourne and (later) Sydney and Canberra, were forced to stay at home for weeks on end, curtailing spending. Over the course of 2020 and 2021, an increasing proportion of the Australian labour force was able to negotiate with their employers to work in their own home, thereby lessening the already substantial impact of the social distancing rules on economic activity.

COVID ended Australia's almost three decades record run of GDP growth and generally sound budget management at the federal level. In fact, the additional public deficits and debt have been so large and unprecedented that COVID represents a clear structural break from past fiscal performance. Before 2019–20, and notwithstanding the inevitable and often large swings in Australia's terms of trade, Australia had achieved a steady and predictable

1 Hereafter, 'COVID' will refer to the coronavirus disease (COVID-19) caused by the severe acute respiratory syndrome coronavirus 2 (SARS-CoV-2). See: www.who.int/emergencies/diseases/novel-coronavirus-2019/technical-guidance/naming-the-coronavirus-disease-(covid-2019)-and-the-virus-that-causes-it.

economic growth path based on generally prudent economic policies, an inclination towards economic reform, and relatively strong population growth.

Australia's federal public financial management performance has been, generally, lauded by international institutions such as the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) since the 1990s. For example, in its 2006 Economic Survey of Australia, the OECD observed that while Australia 'has been riding the global boom in commodities' it has 'also made its own luck through a series of structural reforms and the introduction of a robust macroeconomic framework which have bolstered resilience'. The OECD (2006:8) found:

> This is illustrated by its macroeconomic stability in the face of a string of recent shocks, in stark contrast to the macroeconomic chaos which followed the commodities boom of the early 1970s.

More recently, the IMF (2020) concluded:

> Executive Directors commended the [Australian] authorities for the sound macroeconomic management and strong policy frameworks, which have underpinned the resilience of Australia's economy.

All that said, what good are the plaudits for a strong economy and sound fiscal management if not for being able to respond to large unforeseen economic shocks such as this once-in-a-century global pandemic? In that sense, the striving for (if not the achievement of) an Australian exceptionalism in economic policy since the 1980s has served us well, providing the necessary buffer to use overwhelming fiscal and monetary firepower initially in 2020, before more prudently calibrating the policy response towards the end of 2020 and in 2021.

The chapter is set out as follows. First, a discussion of Australia's pre-COVID economy and budget will set the scene and establish the business-as-usual case that, second, Australia's performance during COVID can then be compared to. Third, the chapter will consider whether or not the Australian Government 'overdid it' in terms of its overall response. Fourth, the chapter will look to the future and consider the economic and budgetary challenges Australia now faces and how we might deal with those challenges over the rest of this decade and beyond.

Pre-COVID — Economy

Australia's long run of economic growth in annual terms began in 1991–92 as we climbed out of the 1990–91 recession (where annual GDP declined by –0.4 per cent), the first recession since a more severe downturn in 1982–83 (–2.2 per cent). Over the 28-year period between 1991–92 and 2018–19 (inclusive), Australia's average annual real GDP growth rate was 3.1 per cent, which is marginally below Australia's average annual real GDP growth rate between 1960–61 and 2019–20 of 3.4 per cent. Australia's average annual GDP per capita growth rate over the 28-year period was 1.7 per cent (Figure 9.1).

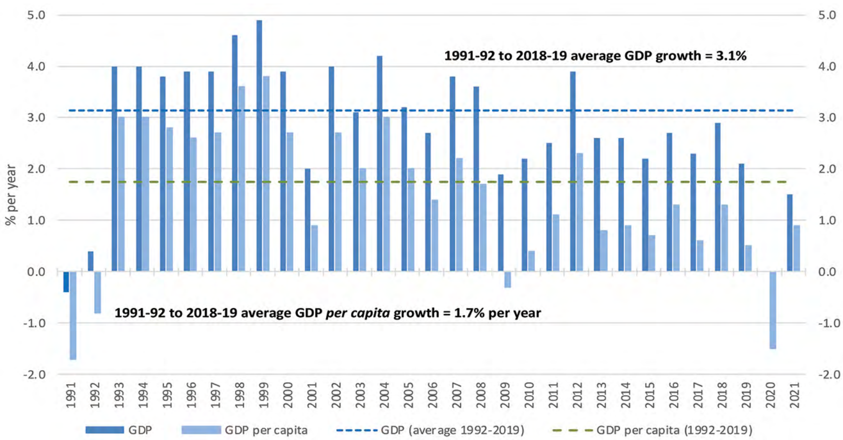

Figure 9.1: Australian annual GDP and GDP per capita growth since 1990–91.

Source: ABS (2021a).

The reasons for Australia's 28-year run of economic growth in GDP terms, and hence Australia's capacity to manage the impacts of the pandemic in 2020 and 2021, are numerous and include continuous population growth, an enormous natural resources endowment, generally good medium-term economic and social policymaking and some good luck.[2]

Perhaps as importantly, Australia's population has been rising strongly since World War II, adding an element of extensive growth to the intensive growth which comes from higher productivity. Over the 28 years of positive annual economic growth, 45 per cent of that growth can be—somewhat

2 In annual terms, 28 years of positive GDP growth is a record for an advanced economy.

roughly—be attributed to population growth.[3] Population growth has also allowed Australia to achieve economies of scale and scope in the provision of government services and a greater degree of industrial diversity, lowering the risks of a negative shock to any one industry causing an economy-wide recession.

Australia also benefits from a tremendous natural resources endowment—a product of being the sixth largest country in the world by land area. Australia is a resources superpower, holding large proportions of the world's useable iron ore, thermal and metallurgical coal, natural gas and uranium. Despite experiencing two of the worst droughts since Federation in the early 2000s (which severely impacted our agricultural commodity exports), the rapid growth in Chinese (and later Indian) demand for Australia's mineral resources drove export prices (and later volumes) to record levels.

As a result, Australia's terms of trade rose strongly from the beginning of the new century until the end of the second phase of the mining boom in 2012, only briefly interrupted by the global financial crisis (GFC) in 2008–09. And despite the mining boom peaking in 2012, our terms of trade (which is the ratio of export prices to import prices) began to recover in 2018 and have well been above their long-run average since the pandemic began (Figure 9.2).[4]

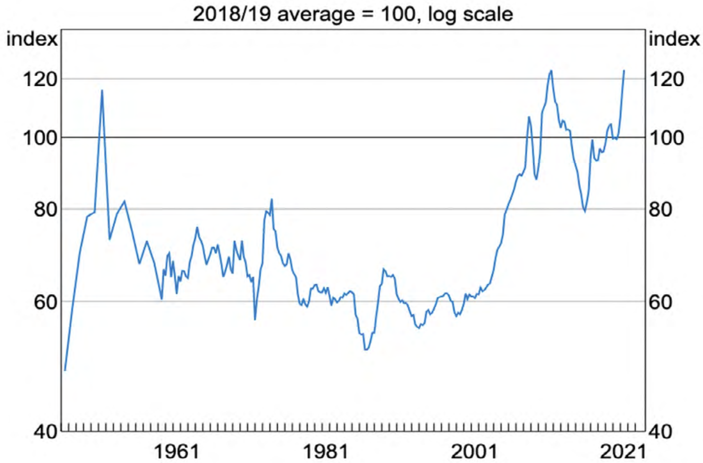

Figure 9.2: Australia's terms of trade (1945–2021).
Source: ABS (2021a); RBA (2021).

3 Estimated as the difference between total real GDP growth and total real GDP per capita growth over the period.

4 A definition and discussion of the terms of trade can be found here: www.rba.gov.au/education/resources/explainers/australia-and-the-global-economy.html.

International comparison

Partly as a result of stronger population growth, Australia's average annual growth rate over the 20-year period to 2018–19 (pre-COVID) was higher than many of its OECD peers such as Canada (2.1 per cent), the United States (2.1 per cent), United Kingdom (1.8 per cent), France (1.4 per cent), Germany (1.3 per cent) and Japan (0.9 per cent). Australia's growth rate was slightly below New Zealand's (3.0 per cent) over the period, and well below its major trading partners Korea (4.1 per cent) and China (9.0 per cent).

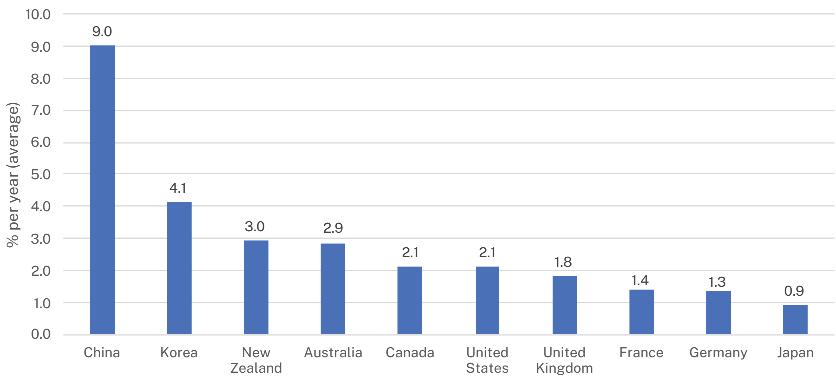

Figure 9.3: GDP growth, Australia's major trading partners.
Source: IMF WEO database (IMF 1999–2019).

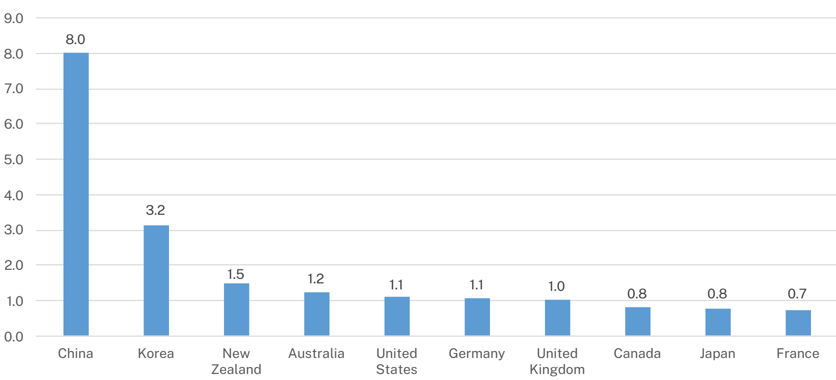

Figure 9.4: Average GDP per capita growth, Australia's major trading partners.
Source: IMF WEO database (IMF 1999–2019).

In per capita terms, Australia's pre-COVID GDP growth (at 1.2 per cent per year, on average between 1999–2000 and 2018–19) has slightly exceeded its developed country peers such as the United States (1.1 per cent), Germany (1.1 per cent), and the United Kingdom (1.0 per cent). New Zealand performed strongly over the 20-year period, with per capita GDP growth of 1.5 per cent per year, on average. China (8.0 per cent) and Korea (3.2 per cent) grew strongly, in China's case reflecting its much lower initial income level.

Pre-COVID budget management

The Hawke Government achieved a significant fiscal tightening in the late 1980s, reducing spending in real terms in 1986–87 (–1.1 per cent), 1987–88 (–0.9 per cent) and 1988–89 (–3.1 per cent), with the effect of shifting the underlying cash balance (a forerunner to the operating balance) from –2.0 per cent of GDP to +1.5 per cent of GDP in just three years.[5] Following the recession and subsequent recovery in the early 1990s, the federal budget position was strengthened in the late 1990s and early 2000s where the Howard Government focused on spending restraint and tax reform. Indeed, by the mid-2000s the Commonwealth had achieved a negative net debt position, a rare feat in the OECD. The Howard Government enjoyed the benefits of the first phase of the mining boom from the early 2000s, which boosted Commonwealth tax revenues and increased Australian households' real incomes as the exchange rate appreciated, making imported goods (like TVs, computers and cars) cheaper for Australian consumers.

This fiscal consolidation achieved in the early years of the Howard Government[6] was maintained until the GFC led to the fiscal loosening that began in 2008–09 under the Rudd Government.[7] From 2013–14, the Abbott and Turnbull governments began to steadily reduce annual budget deficits via expenditure restraint. Consequently, Australia's public net debt was forecast to peak at 19.2 per cent of GDP in 2018–19 and decline to 14.4 per cent of GDP by 2022–23 (Commonwealth of Australia 2019: Statement 10, Table 4).

5 Spending in real terms is calculated using the consumer price index deflator.

6 While the Howard Government maintained operating surpluses throughout its term, there is some debate about whether it went into 'structural deficit' in the final years; that is, it should have saved more of the proceeds from the mining boom to maintain a structural balance.

7 While some degree of fiscal loosening was necessary to respond to the potential (unknown) impacts of the GFC, there is debate around the scale and ultimate effectiveness of the response. See Makin (2010).

State and local budgets

Australia's states and territories are an important part of the fiscal picture. In 2019–20, the second tier of the federation accounted for 23 per cent of total public revenue raised, and local governments (the third tier) accounted for a further 7 per cent (ABS 2022b). While the Commonwealth Government maintains most of the revenue-raising power, the states have most of the non-defence service delivery responsibility, notably for the provision of police and emergency services, public hospitals and school education services. However, with the Commonwealth raising some 70 per cent of revenues, about 50 per cent of state and territory government expenditure is funded by the Commonwealth through direct transfers (grants). Local governments also rely on state and federal government grants to supplement local council rates and charges, especially for new infrastructure projects such as local roads and new recycling centres. The immediate pre-COVID improvement in the total 'federation' fiscal balance was caused by the reduction in the Commonwealth Government's fiscal deficit being larger than the increase in the state governments' fiscal deficits, which had tripled between 2016–17 and 2018–19 (Figure 9.5). Local governments have maintained—and are largely required to maintain—consistent fiscal surpluses in recent years.

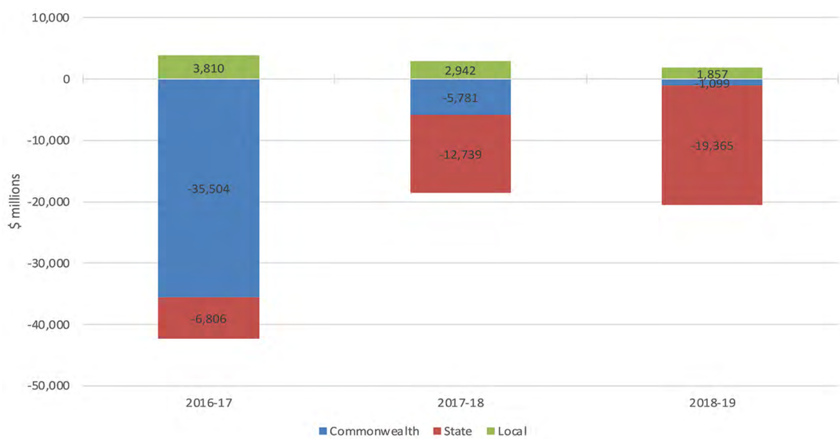

Figure 9.5: Pre-COVID fiscal balance, all levels of government.

Note: The fiscal balance (also defined as 'net lending/borrowing') includes the effect of infrastructure investment.

Source: ABS (2018–20).

The COVID period (2020–21)

Economy

Australia's enviable record of 28 years of uninterrupted growth (in annual terms) ended with the 'COVID recession'[8] in the first half of 2020 when the economy contracted by 0.3 per cent in the March quarter 2020 and a further 7.0 per cent in the June quarter (quarterly, seasonally adjusted).[9] The economy subsequently rebounded (albeit off a significantly lower base) by 3.6 per cent and 3.2 per cent in the September and December 2020 quarters respectively. In 2021, the economy continued easing off its rebound trajectory, growing by 1.9 per cent in the March quarter before declining again to its long-run average (since December 1973) of 0.7 per cent in the June quarter. In per capita terms, it is interesting to note that, in the June, September and December quarters of 2020, GDP and GDP per capita growth were almost identical—indicating the sudden halt in Australia's population growth through that period (Figure 9.6).

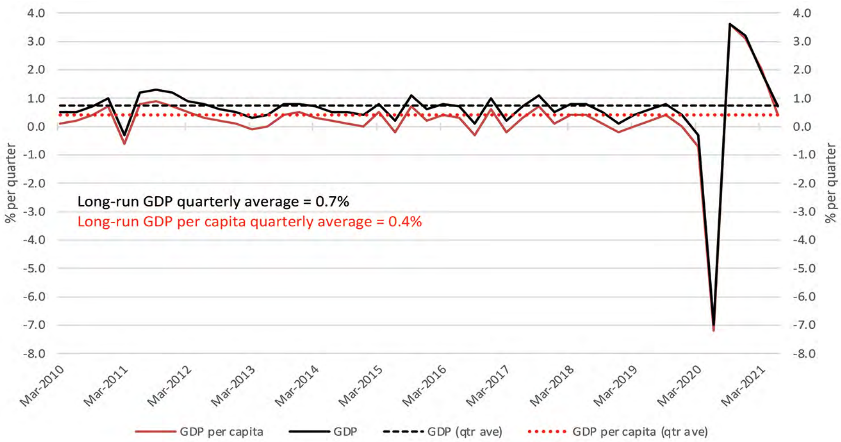

Figure 9.6: Australian quarterly GDP and GDP per capita since 2010.
Source: ABS (2022a).

8 In Australia, the definition of a recession is generally accepted to be two consecutive quarters of negative GDP growth.
9 The ABS has temporarily suspended calculating trend estimates for most economic indicators.

In annual terms, the picture is less dramatic. The Australian Bureau of Statistics (ABS) first estimated that the Australian economy contracted by 0.3 per cent in 2019–20 (or by AUD5.6 billion). However, the ABS subsequently revised its 2019–20 GDP estimate to be 0.0 per cent (i.e. zero growth) when it published the 2020–21 National Accounts in October 2021. In fact, in dollar terms GDP contracted in 2019–20 by AUD76 million, which is clearly far less than was initially feared (ABS 2021a).[10]

Nonetheless, based on the ABS' revised estimate, relative to its long-run trend growth rate (of 3.1 per cent per year between 1991–92 and 2018–19 inclusive), as at 2020–21 the economy is around AUD90 billion smaller in GDP terms than it would likely have been without the pandemic.[11]

Despite suffering the largest economic contraction since the Great Depression in June 2020 (of 7.0 per cent in quarterly terms), the policy response made the pandemic's impact on the Australian economy mild,[12] relative to many other countries. For instance, in the June quarter 2020, there were falls of 12.2 per cent in New Zealand, 11.5 per cent in Canada, 13.8 per cent in France and 19.8 per cent in the United Kingdom (Commonwealth of Australia 2020). These declines in output have been many times larger and much more widespread globally than during the GFC in 2008–09. In annual terms, Australia's revised GDP growth figure in 2019–20 (of 0.0 per cent) highlights just how mild the contraction was compared with New Zealand (–1.7 per cent), the United States (–3.5 per cent), Canada (–4.8 per cent) and the United Kingdom (–9.8 per cent).

Equally, the contemporaneous rise in the household savings ratio, which increased from around 0 per cent to over 20 per cent during the middle of 2020,[13] reflects the resilience of household incomes in the face of the pandemic-induced restrictions on economic activity.

10 Real GDP declined from $1,980,942 million in 2018–19 to $1,980,866 million in 2019–20, which rounded to 0.0 per cent at one decimal place.

11 That is, applying the average annual growth rate of 3.1 per cent to 2019–20 and 2020–21 (of the 2018–19 base year), Australia's GDP in 2020–21 would have been approximately $90 billion larger than the actual outcome (ABS (2022a)).

12 The June 2020 quarter contraction of 7.0 per cent is far greater than previous quarterly contractions in the 1991 and 1983 recessions, and not seen since the Great Depression. In annual terms, the 0.3 per cent contraction in 2019–20 is equivalent to the 1990–91 recession in annual terms (–0.4 per cent) and smaller than the 1982–83 recession (–2.2 per cent).

13 For a definition of the household savings ratio, see: www.abs.gov.au/AUSSTATS/abs@.nsf/Lookup/5202.0Main+Features12007?OpenDocument.

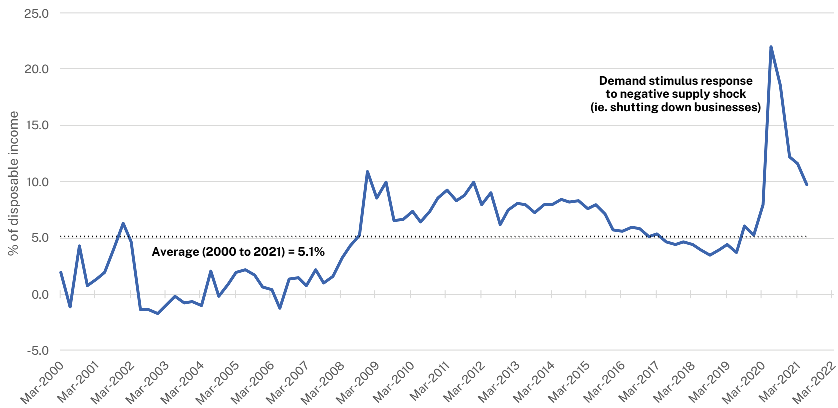

Figure 9.7: Household savings ratio, 2000–2021.

Source: ABS (2021a), September 2021 quarter.

Despite Australia's fiscal stimulus, which included the JobKeeper Program (see Box 9.1), Australia's unemployment rate rose sharply in the middle of 2020. Taking a longer perspective, the rise wasn't particularly out of the ordinary. For example, Australia's unemployment rate peaked at 11.2 per cent in December 1992 following the 1990–91 recession. More recently, Australia's unemployment rate began a long decline from over 7 per cent in the early 2000s to be (albeit briefly) under 4 per cent at the height of the first phase of the mining boom (in 2007) where the economy operated (albeit briefly) under (arguably) Australia's most flexible industrial relation laws since state wage boards in the 1920s extended the Harvester Judgement of 1907.[14] As the unemployment rate rose in 2008–09 with the GFC, the Rudd Government introduced a less flexible system of labour laws which (arguably) held Australia's unemployment rate above 5 per cent until the current post-COVID decline.

Australia's unemployment rate only briefly exceeded 7 per cent at the height of the COVID disruption in mid-2020. The Commonwealth Government's JobKeeper Program allowed large parts of the economy (such as in tourism and hospitability) to be placed in 'deep freeze' and, hence, avoided a potentially much higher unemployment rate. The JobKeeper Program was wound back towards the end of 2020.

14 The *Workplace Relations Amendment (Work Choices) Act 2005* (Cth) came into effect on 27 March 2006 and was repealed (and replaced by the *Fair Work Act 2009* (Cth)) on 1 July 2009. The Harvester Judgement (*Ex parte H.V. McKay* (1907) 2 CAR 1) set in train the development of industry-wide (in the 1920s), and later, economy-wide, minimum wages in Australia. The decision can be found here: www.fwc.gov.au/documents/history/1907_2_car_1.pdf.

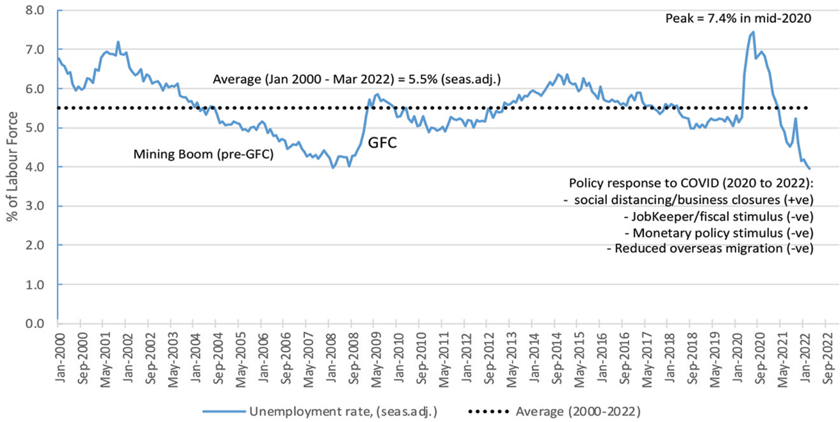

Figure 9.8: Unemployment rate, 2000–2022.
Source: ABS (2022c).

Given the shocks Australia has endured in the past two years, it is remarkable that Australia's unemployment rate had declined to 4 per cent by February 2022 and remains at this level in March 2022. One explanation for this low rate is the shutting of the international border to overseas students and workers, and in particular seasonal workers from Asia and the Pacific Islands through the COVID period. While acknowledging that 'the closure of borders has affected some segments of the labour market' (e.g. hospitality and agriculture), the RBA Governor Philip Lowe has argued that the main driver of the current low unemployment rate is not the closed borders but, rather, the powerful combination of fiscal stimulus and monetary policy support 'that we haven't seen for a long time' (Duke 2022) (Figure 9.8).

Another important influence on the reported unemployment rate is the participation rate, which declined in April–May 2020 and again in September–October 2021 as workers opted to leave the labour market during the economic difficulties. All else equal, a decline in the participation rate will result in a lower than otherwise measured unemployment rate. An alternative way to look at the 'double dip' in the participation rate is to look at the number of Australians over 15 years not in the labour force through the same period. That number increases from 7 million to just under 7.8 million in April 2020 and from 7 million to just under 7.5 million in September 2021 (Figure 9.9). The number not in the labour force fell to just below 7 million in December 2021 and is currently marginally above 7 million as at March 2022.

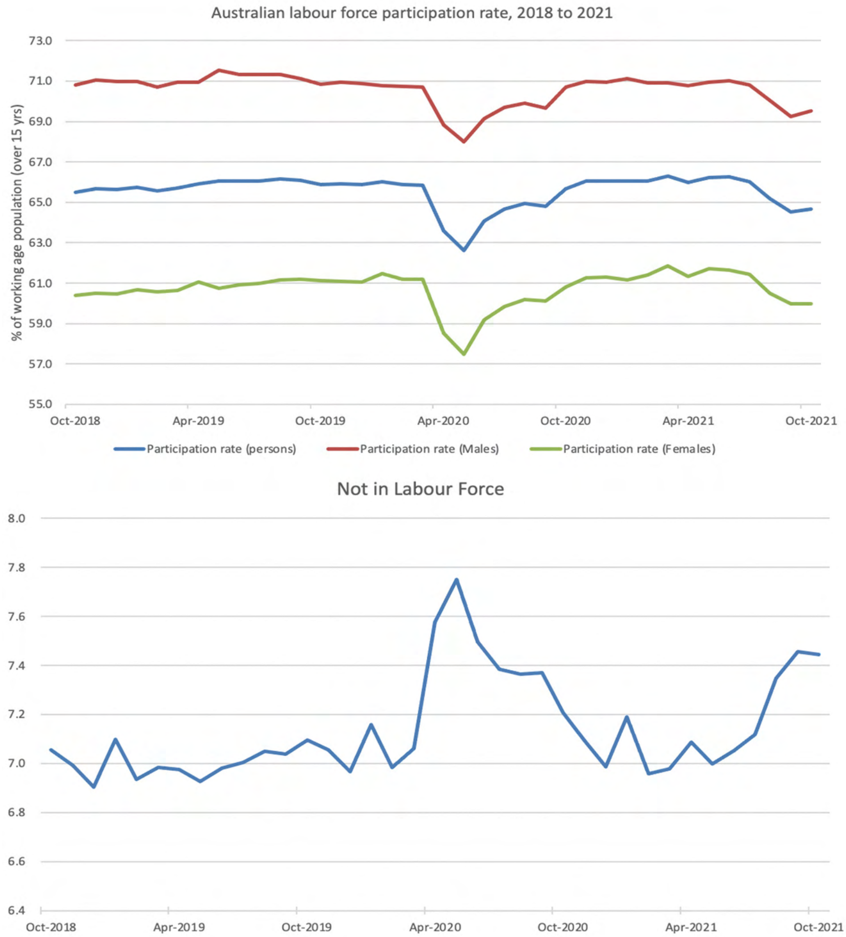

Figure 9.9: Participation rate (top) and population 'not in labour force' (bottom), 2018–21.

Source: ABS (2022c) (seasonally adjusted, LHS; original, RHS).

Prospects for population growth

Since 1982, Australia's population has increased by 1.4 per cent per year, on average. Of that increase, 1.0 per cent per year, on average, can be attributed to natural increase (births less deaths). A simple supply-side model for thinking about economic growth is the '3 Ps' framework, where economic growth is caused by growth in population, labour force participation and productivity. In this model, in very simple terms, since the 1960s Australia's

population growth has contributed roughly half of Australia's growth in GDP with the remainder attributed to productivity and participation growth (Figure 9.10).

Accordingly, a potentially significant future drag on economic growth could come from a softening in population growth post-COVID. Overseas migration has been a critical part of Australia's population and economic growth, as working-age migrants are favoured under Australia's migration policies. That said, rapid population growth also imposes costs, notably in terms of social overhead capital, so its stimulus to economic growth—notably in per capita terms—is likely to be far lower than the 3 P model would suggest.

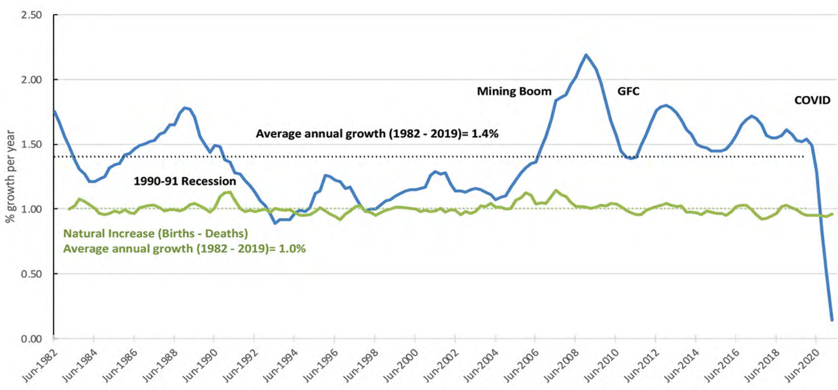

Figure 9.10: Australian population growth since 1982.
Source: ABS (2021c).

The 2021 Intergenerational Report (IGR), which is prepared by the Australian Treasury Department, was released after the initial short-term effects of the COVID shock were evident. The long-term impacts of COVID on the fundamental drivers of economic growth are, of course, as yet unknown.

The central conclusion of the IGR is that COVID will have an enduring negative effect, primarily via a slower rate of population growth compared to the past 40 years. In summary, the IGR concludes:

> The COVID-19 pandemic is causing a demographic shock that will be evident in Australia's population for years to come, with temporarily lower inward migration as well as expected delays in women having children. Alongside the shock from the COVID-19

> pandemic, the long-run fertility rate is expected to be lower than previously estimated. Migration is expected to continue to be the largest source of population growth in the long term. (Commonwealth Treasury 2021:13).

While migration plays a role in offsetting Australia's ageing population, the effect is tempered by the fact that migrants are generally of working age. The 2021 IGR has forecast a flat rate of overseas migration, at 235,000 overseas migrants per year from the mid-2020s until 2060–61. Therefore, Australia's rate of migration as a proportion of the population is forecast to decline from around 0.9 per cent of the population in the mid-2020s to around 0.6 per cent of the population in 2060–61.[15]

The bulk of these migrants are assumed to be of working age, adding to Australia's labour force. Treasury IGR analysis shows that an increase in overseas migration benefits the budget because Australia's migration program targets skilled migrants of working age. Obviously, that does not imply migration necessarily raises overall welfare, given the costs noted above.

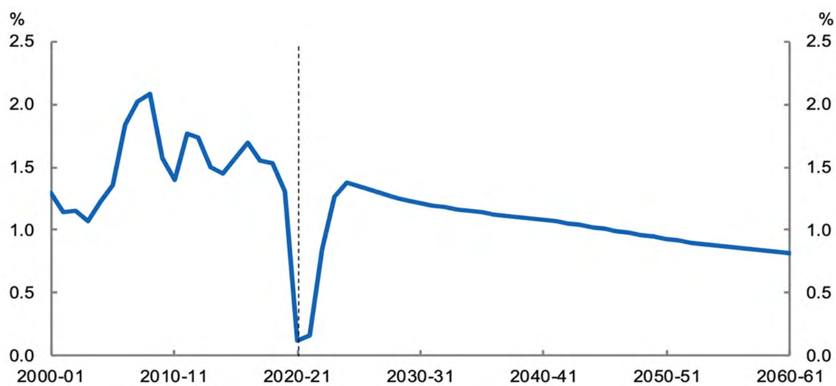

Figure 9.11: Australia's population growth rate, IGR 2021 forecast.
Source: ABS (2021d); Commonwealth Treasury (2021).

15 The 2022–23 Federal Budget (released 29 March 2022) estimated Net Overseas Migration (NOM) as follows: –89,900 in 2020–21; 41,000 in 2021–22; 180,000 in 2022–23; 213,000 in 2023–24; 235,000 from the mid-2020s (Commonwealth of Australia 2022).

Federal budgets during COVID

The initial and subsequent fiscal response to COVID had (at the end of 2021) amounted to well over AUD300 billion in health, household and business support to keep businesses in business and Australians in jobs. About one-quarter of the total fiscal expenditure related to the JobKeeper Program (AUD89 billion), and a further AUD50 billion was 'spent' in tax relief for households and small businesses (Box 9.1).[16]

Box 9.1: Key measures in the Commonwealth's COVID-19 response package

- Total expenditure was AUD311 billion.
- The JobKeeper Program totalled AUD89 billion, supported 3.8 million workers and is estimated to have reduced total employment losses by 700,000 at the peak of the crisis in April–July 2020.
- More than AUD50 billion in tax relief for households and small businesses.
- Support for business including tax relief, accelerated depreciation for new capital purchases, 50 per cent wage subsidy for new apprentices and trainees (AUD1.2 billion), JobMaker Hiring Credit (AUD4 billion) (not to mention JobKeeper).
- Eased access to superannuation.
- Additional economic support payments for pensioners (AUD2.6 billion).
- Support for universities and, in particular, vaccine development (AUD1.7 billion).
- Increasing infrastructure investment pipeline by AUD10 billion.
- Supporting measures by the independent RBA including lowering the cash rate and massive bond buying program.

Source: Commonwealth of Australia (2021).

The economic contraction reduced forecast annual federal revenues substantially, from AUD551.0 billion (as at the 2019–20 Budget) to AUD482.1 billion (as at the 2021–22 Budget). And the measures to support Australian businesses and households increased government expenditure to unprecedented levels, from AUD533.2 billion (as at the 2019–20 Budget) to AUD588.7 billion (as at the 2021–22 Budget). The result is an underlying cash balance that, after a decade of painstaking work to stabilise it post-GFC, deteriorated by (on average) AUD124 billion per year over the period 2019–20 to 2022–23 (Table 9.1).

16 Tax cuts are sometimes referred to as 'tax expenditures', thus equating notional foregone revenues with cash outlays, which is obviously questionable both analytically and in practice.

Table 9.1: Underlying cash balance, as at 2019–20 and 2020–21 budgets.

Underlying cash balance (AUD, $b)	2019–20	2020–21	2021–22	2022–23	2023–24
2019–20 Budget	7.1	11.0	17.8	9.2	n/a
2020–21 Budget	–85.3	–161.0	–106.6	–99.3	–79.5
Difference	–92.4	–172.0	–124.4	–108.5	n/a

Source: Commonwealth of Australia (2019, 2020).

The fiscal balance, which is a more accurate measure of the annual call on borrowings (because it accounts for the effect of net infrastructure investment) worsened from a sliver of a surplus in 2018–19 (0.1 per cent of GDP) to a deficit of –7.9 per cent of GDP in 2020–21 before (its forecasted) improvement to less than 3 per cent of GDP in 2024–25. Despite that hoped-for improvement back towards fiscal balance, any annual negative deficit figure adds to the call on borrowings and, thus, the stock of net debt (all things being equal).

However, as a result of the unprecedented fiscal loosening that began in the first half of 2020 (i.e. 2019–20), the actual net debt outcome in 2018–19 of 19.1 per cent of GDP has deteriorated to a forecast 40.9 per cent of GDP in 2024–25, while gross debt is forecast to be even higher at 50.0 per cent of GDP by mid-decade (Commonwealth of Australia 2021: Statement 11, Table 11.4).[17] Taking the longer view, from an impressive *negative* net debt position of almost 4 per cent of GDP in 2007–08, the Commonwealth's budget position in the general government sector has worsened by 45 per cent of GDP in 17 years (Figure 9.12).

In dollar terms, Commonwealth net debt will increase from a forecast AUD326.1 billion in 2022–23 (as at the 2019–20 budget) to AUD835.0 billion in the same year (as at the 2021–22 budget). And Commonwealth net debt is now forecast to be just under AUD1 trillion in 2024–25.

17 Gross debt is defined at the total face value of Australian Government Securities (AGS) on issue. Unlike some state and territory governments, there is not a large difference between net debt and gross debt as the Commonwealth owns too few government-owned corporations (i.e. assets) to offset the gross debt figure.

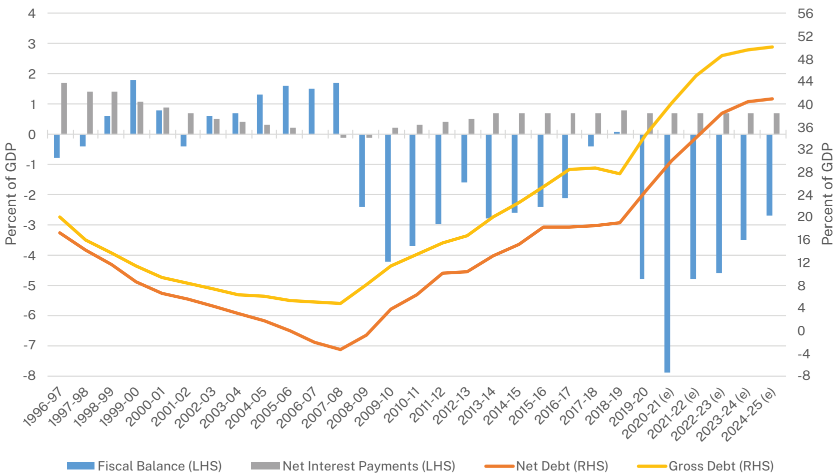

Figure 9.12: Commonwealth budget parameters, 1996–97 to 2024–25.
Source: Commonwealth of Australia (2022).

International comparison of budgets

That said, compared to its OECD and major trading partner peers, Australia's fiscal position has moved from being 'very strong' to just 'strong'. For example, Australia's immediate deterioration in the fiscal balance (between 2019–20 and 2020–21) was relatively mild at 6.1 per cent of GDP. While China (–5.5 per cent of GDP) and Korea (–3.6 per cent) experienced a smaller deterioration than Australia, the worsening in the fiscal balance was greater in many other advanced economies, including the United States (–12.4 per cent), the United Kingdom (–14.6 per cent) and Canada (–19.6 per cent) (see Figure 9.13).

Taking a slightly longer view, Australia also compares well when looking at the forecast deterioration in net debt between 2019–20 and 2025–26. While Australia's net debt position worsens by 'only' less than one-fifth of GDP, six of Australia's peers worsen between just under one-quarter to almost one-third of GDP, with the United Kingdom (31.7 per cent) and New Zealand (30.4 per cent) both exceeding a 30 per cent deterioration.

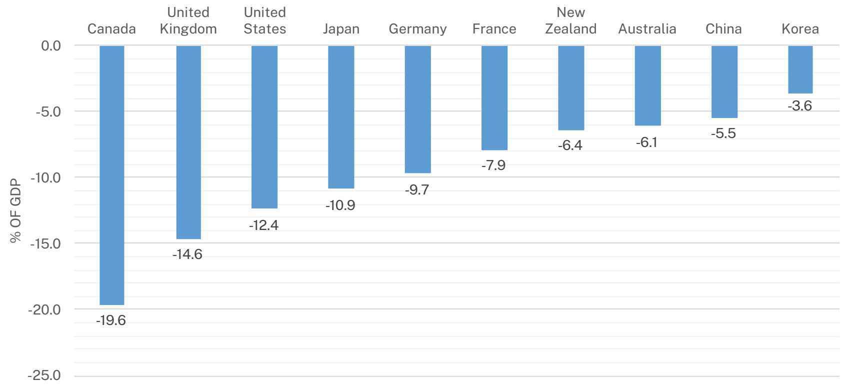

Figure 9.13: Fiscal balance deterioration between 2019 and 2020.
Source: IMF (2021).

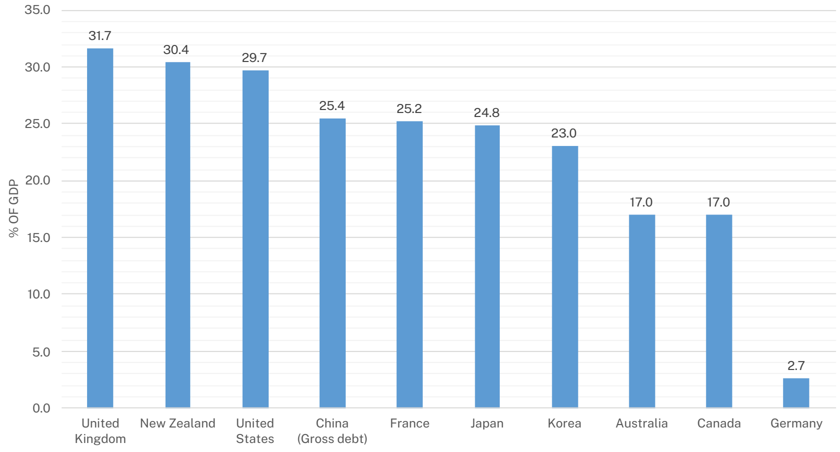

Figure 9.14: Net debt deterioration between 2019 and 2025.
Source: IMF (2021).

State and territory budgets

Taking into account the position of Australia's second and third tiers of government, Australia's overall fiscal position collapsed in the June and September quarters 2020, when the total quarterly fiscal deficit exceeded AUD100 billion. The annual calendar year fiscal deficit in 2020 was AUD266 billion or 13.3 per cent of GDP.

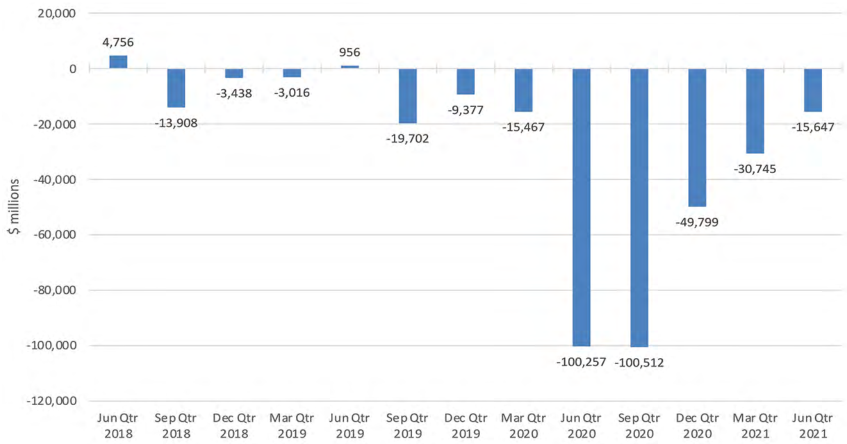

Figure 9.15: Fiscal balance, all levels of government (June 2018–June 2021).
Source: ABS (2021b).

Economic and budget outlook

Domestic economy and trade

Is the COVID crisis sufficient to trigger another wave of economic and fiscal reform? Is Australia still exceptional in economic policymaking terms or is the widely accepted two-decades-long 'reform period' from the early 1980s until the early 2000s an anomaly? And what luck can Australia hope to rely on over the next three decades towards mid-century?

While Australia still possesses enormous reserves of natural resources, it seems that the global trend will be away from coal-fired electricity generation towards renewables of varying efficiency and cost. Moreover, the likelihood of a mining boom the size of the 2004–2011 vintage recurring seems remote given reductions in China's growth rates, and its shift to a more services-based economy, and the bottlenecks which hamper India's growth performance. On the other hand, Russia's full-scale invasion of Ukraine has presented opportunities for Australia to be a reliable supplier of energy resources, rare earths and processed metals to countries formally reliant on Russian supplies.

Luck is not easily forecast. Much of Australia's good fortune has been built on steady population growth and occasional sustained surges in global demand for goods or services that we are good at providing—from wool in the 1950s, to iron ore and metallurgical coal, thermal coal, and (lately) natural gas, lithium, education services and tourism.

More fundamentally, it is likely that Australia's robust democratic system will continue to foster generally good policy outcomes although those deliberations are always subject to the zeitgeist of global political and cultural preferences.

The future for productivity growth is highly uncertain and relates, in the long run (all things being equal) to the rate of technological progress (or innovation), as well as on the capacity of the economy to shift output from lower to higher productivity uses. On the one hand, the pandemic has potentially pulled forward productivity- (and welfare-) enhancing developments in relation to the use of digital infrastructure and working from home. On the other hand, COVID has interrupted schooling and university educations, as well as apprenticeships and early career training. The productivity-enhancing factors could still predominate over time, so long as policies in transport and land use planning and industrial relations keep pace with technological progress and cultural developments.

Second, it may be that we were already on a somewhat slower growth trajectory, partly because of lower multifactor productivity growth and a (difficult to entirely explain) reduction in capital formation. Were there also slower population growth going forward, that would aggravate the slowdown (see Figure 9.16).

Finally, Australia, as a relatively small open economy, relies on a free and dynamic global trading system, including for services trade (such as education services). Moreover, Australia has rarely prospered when the world economy is in the doldrums. Prior to the pandemic there was some trade tension between Australia and China, with China taking a number of measures against Australian exports (Table 9.2). To the extent that trade tensions arise and persist, then Australia's growth prospects are reduced. It will be interesting to see how Australia's tertiary sector recovers in 2022 and whether the number of Chinese students attending Australian universities returns to pre-COVID levels.

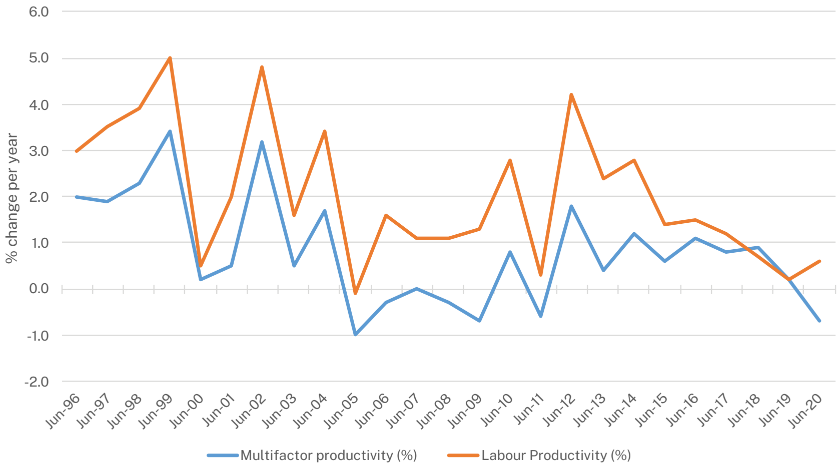

Figure 9.16: Market sector productivity growth, 1996–2020.

Source: ABS (2020).

Table 9.2: Recent trade tensions between Australia and China.

Commodity/Sector	Summary of Chinese measures against Australia
Barley	80% tariff; CBH and Emerald Grain suspended; has effectively suspended the AUD1 billion export market.
Beef/lamb	8 abattoirs blocked; 4 beef exporters blacklisted; partly COVID de-listing; AUD3 billion export industry.
Wine	Hold-ups at ports (unofficial ban); then 200% tariff for 'dumping' + 6% tariff for 'countervailing duties'; AUD1.3 billion industry effectively halted.
Cotton	Unofficial ban with buyers told to stop buying Australian cotton; rumours of impending 40% tariff; AUD800 million export industry.
Lobster	Unofficial ban with lobsters left on the tarmac at customs; importers warned off buying Australian lobster; AUD771 million export market.
Timber	Stronger quarantine measures (detection of bark beetle) resulted in 4 Australian states banned from exporting; AUD1.9 billion industry.
Coal	AUD700 million in coal shipments stranded waiting for port entry; fourth quarter (2020) exports had fallen by 82% and Australia's largest coal port, Newcastle, had completely stopped sending coal to China altogether. AUD14.5 billion export trade.
Foreign students	Tourists have been discouraged from visiting Australia while Chinese students have been told to look at other countries for their education — although COVID has prevented this from occurring at the moment.

Source: BT (2020).

Monetary policy prospects

The RBA acted to support the economy during COVID by keeping its benchmark interest rate at, effectively, zero per cent and expanding its balance sheet. In its most recent *Statement on Monetary Policy* (November 2021), the RBA stated that the current (end of 2021) package of monetary policy measures are accommodative.

> By lowering the structure of interest rates, funding costs across the economy remain very low, despite the recent rise in market yields, and the exchange rate is lower than it would otherwise be. (RBA 2021:4)

To that extent, monetary and fiscal policy in Australia worked in tandem during the pandemic, increasing their efficacy. In contrast, during the GFC, the Rudd Government's fiscal stimulus was partly offset by the RBA cautious monetary stance, contributing to an appreciation in the exchange rate which blunted economic growth.

Global interest rates have increased substantially since 2021 when the Federal Reserve Board in the United States began to wind back its asset purchase program (Federal Reserve 2021). It increased its Federal Funds rate from an historic low of 0.1% in July 2021 to 4.65% in March 2023. The RBA has followed suit raising the cash rate ten times (or by 3.5 percentage points in total) between May 2022 and March 2023, from an historic low of 0.1% to 3.6%.

Prospects for fiscal management

As discussed, absent another major negative economic shock, Australia's fiscal position is forecast by the Commonwealth Treasury to stabilise and then improve by the end of the decade. However, there are several risks to this outlook, most notably the possibility of slower population growth, which affects both the revenue and expenditure sides of the budget, and higher health expenditures to manage population ageing.

In its latest *Beyond the Budget* 2021–22 report, the independent Parliamentary Budget Office (PBO 2021) found that while the Commonwealth Government's fiscal position is projected to improve over the decade, the enduring impact of COVID remains 'profound and uncertain'. The PBO found that:

- The level of government debt matters, as does the quality and efficiency of public spending, whether for services or (infrastructure) investments;
- It would be more difficult for Australia to maintain a fiscally sustainable position if future shocks are consistently larger or more frequent; and
- Structural increases in payments, especially related to the National Disability Insurance Scheme (NDIS) are a real threat to fiscal sustainability.

Looking at the Commonwealth budget position soberly, there is no doubt that Australia's fiscal position is more vulnerable than at any time this century. In addition, Commonwealth payments for aged care and the NDIS continue to rise faster than economic growth. Moreover, the state and territory budget positions are also more vulnerable because of COVID.

There also remains some uncertainty over Australia's future population growth trajectory. While Australia's rate of natural increase is positive and stable, it is low, with the prospects for fertility likely to remain unchanged. On the other hand, the good prospects for longevity are likely to place pressure on the budget position because of the call on increased welfare payments without a corresponding increase in income tax revenues. And while there is obviously scope for the Commonwealth Government to increase revenues as a share of GDP, there is an economic cost to doing so,[18] especially since overall revenue from all three levels of government exceeds one-third of GDP already (IMF 2021).[19]

Did Australia over- or under- do it?

Government had a duty to support Australians

After a tumultuous two decades of riding the terms of trade roller-coaster, the moment it was required Australia had the economic and fiscal firepower to shut down large sections of the economy and pay citizens to stay at home. Relative to its advanced economy peers, Australia began 2020 in a strong

18 A well-known finding in economic theory is that the economic cost of a tax rises with the square of the tax rate.

19 The October 2021 edition of the IMF Fiscal Monitor estimates Australia's general government revenue at 36.1 per cent of GDP in 2020 and 34.3 per cent of GDP in 2021 (see IMF 2021:Table A5). This level is roughly in line with the G7 economies average and 10 percentage points below the Euro Area average.

position, in terms of its economic growth rate, the unemployment rate and fiscal strength. Population growth, which averaged 1.6 per cent per year over the three years before COVID, was also relatively strong.

Perhaps partly as a result of this strength, it could be argued that Australia's fiscal and monetary response to the pandemic has been, with the benefit of hindsight, overdone. That said, the Commonwealth Government's original expectation was to go much further in terms of fiscal support, for example budgeting for a far higher take-up of the JobKeeper Program than was ultimately realised.

The 2022–23 Federal Budget, delivered on 29 March 2022, showed a significant improvement in the fiscal outlook. There has been a AUD103.6 billion improvement in the underlying cash balance in the general government sector between the previous year's mid-year update and the 2022–23 Budget. The turnaround has been driven by stronger economic conditions, higher resources prices and a stronger than expected labour market recovery (Commonwealth of Australia 2022).

There is no doubt that the Australian Government (and state and territory governments) needed to respond to the consequences of social distancing and other policies that had not been seen in Australia since the Spanish Flu pandemic that followed World War I. And in that sense, the Australian Government and its state counterparts had no alternative. After all, these governments were shutting down shops and workplaces in the pursuit of a greater good; that is, taming the pandemic and 'flattening the curve' to preserve the effectiveness of Australia's health system.

In this regard, the Commonwealth had a duty to compensate citizens via its AUD311 billion fiscal package for, essentially, three reasons.

- First, because the decision to shut those non-essential economic activities was one the government took, rather than the owners of those businesses, and so it was causing costs for which it should bear responsibility.
- Second, because this was an uninsurable event, and the government, with its capacity to smooth costs over time, was the least-cost risk bearer, just as it would be in a war.
- Third, because if compensation hadn't been provided, the social fabric would have been shredded and confidence in government shattered, causing enduring social and political problems and undermining policy effectiveness for years to come.

Lessons from the GFC stimulus

That said, the justification for the intervention doesn't answer the question whether the Commonwealth and/or state and territory governments over- or underdid it. To answer this question, first it should be recognised that any public expenditure carries an opportunity cost including the cost of borrowing and raising future taxes to pay back those borrowings. A further issue to consider is the timing of the stimulus. The COVID spending largely avoided the pitfalls of a large part of the GFC spending, because it was predominantly expenditure- rather than investment-based and, therefore, was 'shovel ready' in the sense that the money was paid directly to individuals and business owners.

That said, there is some evidence that the JobKeeper payments were overdone. Many businesses, for example, paid back the JobKeeper moneys that they had claimed voluntarily.[20] And, as discussed above, the Australian Household Savings Ratio increased markedly from around zero per cent of disposable income at the beginning of 2020 to over 20 per cent by mid-2020, reflecting the supply-side nature of the economic shock (see Figure 9.7 above).

However, in reality, it is unlikely that governments had the time in which to design a better targeted set of measures. And the Commonwealth did adjust eligibility as conditions stabilised. Overall, the most that can be said is that the government adopted a risk-averse approach, preferring to err on the side of doing too much than too little. Given the almost complete uncertainty which permeated policymaking during this period, and the potentially catastrophic consequences had the response been underdone, that choice may well have been wise, though it (and the details of the response) will be debated for years to come.

Conclusion — where to from here?

Australia's economic future remains bright. While it's true that Australia will need to 'remake its case' to overseas citizens contemplating a better life elsewhere, it's not a hard case to make—after all, Australia remains a relatively stable, tolerant and safe democracy full of opportunity and far

20 Ultimately, dozens of ASX-listed companies voluntarily returned (albeit with some public reputational pressure) JobKeeper payments to the Commonwealth Government.

away from the turmoil in Eastern Europe and other parts of the world. Accordingly, with a return to a steady population growth rate of 1–2 per cent per year and sound economic and budgetary policy settings, Australia has the natural resource endowments, institutional frameworks and good fortune to continue to prosper.

In relation to population growth, the 2021 IGR has been, arguably, too cautious in its post-COVID population growth forecasts, most notably in relation to its numerical (as opposed to proportional) migration ceiling assumption of 225,000 per year. The threats to the economy from COVID do not appear to be enduring and, indeed, some impacts might prove to be positive (such as the structural shift to working from home which will draw more workers into the labour force). These developments, not possible perhaps even a decade ago (e.g. due to not enough internet bandwidth, too much communications latency) have enhanced our ability to absorb the COVID shock and probably reduced the lasting impacts, facilitating a very speedy recovery. Therefore, the threats to Australia's fiscal sustainability are just as likely to emanate from 'bad policy' as some future negative shock.

As at end-November 2021, more than 85 per cent of Australians over 16 years have been fully vaccinated against COVID-19.[21] And, as at 31 March 2022, Australia's internal borders are open to commerce and travel, and virtually all social distancing measures and related policies have been wound back (e.g. checking-in or showing vaccination certificates at cafés and supermarkets). That said, new Omicron subvariants remain a threat to economic growth.

As at early April 2022, it is also looking increasingly like the Australian economy will return to its pre-COVID dynamism. As argued, the recession was a result of putting the economy in a 'deep freeze', which may have some lasting economic, social and health consequences but where, by and large, the economy, once the constraints are removed, is likely to snap back.

There are a number of caveats to this positive outlook, however.

First, it may be that we were already on a somewhat slower growth trajectory, partly because of lower population growth and partly because of lower productivity growth. And given that Australia's long-run trend of increasing

21 If measured as a proportion of the total population, the equivalent fully vaccinated figure is 72 per cent.

labour force participation seems to be coming to an end, the three sources of (supply-side) growth—population, productivity and participation—may need boosting via policy measures this decade.

Second, the IGR is relatively optimistic in terms of the fiscal outlook, essentially because it assumes spending growth can be capped, and in the long run, reverts to some normal level. However, the experience is that restoring fiscal balance is extremely hard, and falls in the outlays/GDP ratio are very rare (see Appendix A). Rather, each increase in spending during a shock has tended to persist.

For instance, the IGR seems to ignore large future spending pressures such as the NDIS, aged care and, potentially, defence spending. Further, the IGR also draws comfort from the fact that our debt/GDP ratio is low by OECD standards, which is no doubt true. However, it should also be said that the fact that (public and private) debt ratios are now so high internationally may well make the world economy more shock-prone, and we would not be spared those shocks, which could make even our (relatively) lower debt/GDP ratio dangerous.

If it is true that global economic shocks are now occurring more frequently, there may not be enough time for the fiscal situation to improve before the next shock hits, even if the IGR's estimates prove reasonably accurate. In other words, to the extent that global shocks are more frequent because economies and societies are ever more interlinked via trade and travel, then global economic shocks will reverberate at stronger levels of fiscal and economic strength (i.e. lower debt levels). It follows that, if we have less time in future to recover from shocks, we need to be more prudent when we first respond to them.

Current interest rates are very low compared to the projected rate of growth of nominal tax receipts, which would normally be viewed as making projected public debt levels, both at the Commonwealth and state/territory level, sustainable. However, interest rates are now nudging up, seemingly returning to the normalisation process which had begun before COVID struck. While it's true that both the Commonwealth Treasury and the PBO see interest payments as a percentage of GDP remaining stable (at around 1 per cent of GDP) over the next decade, those assumptions are based on current interest rate forecasts. A further shock might see interest rates spike if issues arose about government solvency (e.g. in the Eurozone).

Also, the very low rates that now prevail may be partly a symptom of widespread risk aversion; that is, central banks are reacting to (and in the process perhaps aggravating) widespread investor pessimism, and a related decline in long-term growth prospects, which would both weigh on the actual growth of tax receipts and have obvious implications for some of the stimulus spending (e.g. on capacity expansion investment in infrastructure).

A persistent danger to Australia's fiscal sustainability has been the political desire for the 'mega project'—from underground road and rail lines, interstate fast train networks and submarines. While there has been some reform in recent years towards establishing institutional counterweights to political opportunism, the days of the mega project do not seem to be numbered (with Brisbane's marginal-at-best Cross River Rail project well underway). Whether the Australian federation will continue to work through reforms to infrastructure investment remains to be seen; as things currently stand, any disciplined approach to infrastructure decision-making seems to be in abeyance, increasing the likelihood of public expenditure being committed to very large-scale projects whose costs are far greater than the benefits. In this regard, there is a need to further entrench the requirement of independent, public reviews of proposed large infrastructure projects that utilise best practice tools such as cost–benefit analysis.

Finally, if it is true that monetary policy will start to normalise, albeit slowly, while fiscal policy remains stimulative, both at a Commonwealth and state level, then monetary and fiscal policy will be working at cross purposes. The result, as in 2010, will be an appreciation in the real exchange rate which will nullify the stimulative effect of the fiscal spending while still leaving its burden in terms of increasingly costly to finance public debt.

In summary, while one can argue about individual components of the COVID stimulus package, the overall approach of compensating for the costs of government decisions was entirely sensible. And seen in that light, the package was not a stimulus package but rather compensation or assistance in bearing temporary costs and hardships.

Now that the worst is over, the sooner Australian public policy returns to its 'exceptionalist roots' and soberly faces, and prepares for, the possibility of slower growth in its '3 Ps', faster growth in healthcare expenditures and rising global interest rates, the more likely it is that a prosperous future lies ahead.

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Appendix

Table 9.A1: Commonwealth Government general government key budget parameters, 1996–97 to 2024–25.

Year	Underlying cash balance	Fiscal balance	Net debt	Net interest payments
1996–97	–1.1	–0.8	17.3	1.7
1997–98	0.0	–0.4	14.1	1.4
1998–99	0.6	0.6	11.6	1.4
1999–00	2.0	1.8	8.7	1.1
2000–01	0.8	0.8	6.6	0.9
2001–02	–0.1	–0.4	5.6	0.7
2002–03	0.9	0.6	4.2	0.5
2003–04	0.9	0.7	3.1	0.4
2004–05	1.5	1.3	1.7	0.3
2005–06	1.6	1.6	0.0	0.2
2006–07	1.6	1.5	–2.2	0.0

Year	Underlying cash balance	Fiscal balance	Net debt	Net interest payments
2007–08	1.7	1.7	–3.4	–0.1
2008–09	–2.1	–2.4	–0.9	–0.1
2009–10	–4.2	–4.2	3.7	0.2
2010–11	–3.4	–3.7	6.4	0.3
2011–12	–2.9	–3.0	10.2	0.4
2012–13	–1.2	–1.6	10.4	0.5
2013–14	–3.0	–2.8	13.1	0.7
2014–15	–2.3	–2.6	15.1	0.7
2015–16	–2.4	–2.4	18.3	0.7
2016–17	–1.9	–2.1	18.3	0.7
2017–18	–0.5	–0.4	18.5	0.7
2018–19	0.0	0.1	19.1	0.8
2019–20	–4.3	–4.8	24.7	0.7
2020–21 (e)	–7.8	–7.9	30.0	0.7
2021–22 (e)	–5.0	–4.8	34.2	0.7
2022–23 (e)	–4.6	–4.6	38.4	0.7
2023–24 (e)	–3.5	–3.5	40.4	0.7
2024–25 (e)	–2.4	–2.7	40.9	0.7

Source: Commonwealth of Australia (2020).

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