7. Australia's fiscal straitjacket

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Abstract

State governments are finally waking up to the need to get more actively involved in financing of public infrastructure. But at the Federal level, with the current commitment of Coalition and Labor to zero net borrowing over the economic cycle, the public debt straitjacket is becoming even more entrenched. The notion that, over the medium/long term, all general government investment should be financed out of current revenue or through the private sector is plain silly. It is impeding the Government's capacity to meet the nation's infrastructure needs and forcing it to adopt financing options that are economically less efficient than borrowing. It is also contributing to the run down of social capital and denying Australians a genuine, well informed choice on the appropriate balance between public and private goods. The policy needs a rethink.

Introduction

As John Butcher reminds us in Chapter 2, nation-building is about: (a) taming (or should we say working constructively with) nature; (b) building economic infrastructure (such as roads and railways) to remove physical bottlenecks to economic growth; and (c) investing in human capital such as public health, education, housing, employment programs, among others, in order to minimise the risk of skills bottlenecks and, more importantly, to ensure a fair society with genuine equality of opportunity).

If a government is interested in nation-building, the last thing it should be doing is tying itself up in a fiscal straitjacket. Yet this is exactly what the new Rudd Labor Government has done.

The medium term fiscal straitjacket

Like its predecessor, the Rudd Labor Government has promised that over the business (and electoral) cycle:

- tax receipts will not increase relative to gross national product; and
- there shall be no net government borrowing (no increase in public debt).

Effectively, Prime Minister Rudd and his Treasurer, Wayne Swan, have set a ceiling on tax rates and promised that, over the medium term,[1] all federal government spending — recurrent or capital —will be fully paid for out of tax revenue.[2] This extreme form of 'fiscal conservatism' may have helped Rudd win the election but it will make it very difficult for him to deliver a strong report card on his education, health and infrastructure goals.

The structural fiscal goals are not as rigid at the state level[3] but, under our lopsided federal system, it is the Federal Government that has the largest and fastest growing revenue base and the greatest capacity to borrow. So it is the federal fiscal stance that will be crucial for nation-building.

Yet, in my view, (and I am far from alone on this), the federal fiscal stance makes no economic sense. It is based on eight myths or, at best, eight half-truths, which I will explore below.

First myth — that 'higher taxes are bad for economic growth'

Few economists would accept this proposition as a generalisation. Tax increases can have significant incentive costs (although even here there is controversy[4]), with the so-called 'deadweight' (choice distorting, welfare-reducing) costs of higher taxes as high as 20 cents in the dollar. But the net economic cost of tax increases depends on:

- the initial tax levels (as the efficiency costs increase approximately with the square of the tax rate);
- how the revenue is raised (how much it impacts on work incentives and capital movements and how much it distorts choice); and
- how productively the money is spent[5] (how great are the offsetting benefits on the spending side) — for example, the offsets are nil if spending takes the form of 'middle-class welfare' transfers but they are much higher with productive investment in human capital.

With a careful choice of tax instruments and well designed spending programs, the economic benefits of public spending often outweigh the costs, especially in a low tax country like Australia. That is why it is hard to find a significant statistical correlation between size of government (levels of government spending and taxation) and a nation's economic performance.

People who want governments to spend less can mount a general argument based on 'government failure' and the need for a 'disciplined and restrained approach' to public spending. Equally, those who want governments to spend more on infrastructure, education, health care or early childhood intervention can make a general argument for additional spending based on increased wellbeing and social capital gains. But, at this generalised level, the arguments are based on ideology — not economics. Each proposal requiring higher taxation needs to be assessed on its individual merit without any prior presumption for or against.

Second myth — that a 'public debt freeze is the key to sound public finance'

This claim is plainly ludicrous. Net public debt — the difference between the government's stock of financial (mainly debt) liabilities and its financial assets — is not an appropriate measure of a government's balance sheet strength. The focus should be on net public worth — all financial and non-financial assets minus all liabilities. If governments borrow money to invest in real 'productive' assets with a comparable life to the debt, this adds to net public debt but it does not detract at all from net worth and, depending on the investment, could even increase net worth in the long term.

The only prudential requirement on governments should be ensure that, over the medium term, they run a net operating surplus (an excess of current revenue over *current* expenses) and borrow only to invest in physical or human capital projects that have met the standard cost-benefit criteria and have the potential to increase the revenue base in the long term. This should ensure net government worth is stable or rising and that public debt levels are kept at a sustainable level in terms of capacity to service. This is the stance now adopted by state governments and by most other OECD governments.[6] It is only the Commonwealth government that is out of line.

The irony is that Australia's public debt levels are among the very lowest in the developed world (less than five percent of the OECD average, relative to GDP). All Australian governments have very strong balance sheets[7] and our credit rating agencies are generally relaxed about some increase in government borrowing for investment purposes.[8] This should give Australia more — not less — freedom to borrow than other OECD countries.

Third myth — that 'the private sector is always a more efficient owner-manager of infrastructure than government'

As a generalisation, this proposition is simply untrue. While there is little doubt that the private sector is generally better than the public sector in design, construction and operation of infrastructure, capturing these benefits does not require private ownership. Governments can and do out-source most operational matters to private companies and consultants.

The efficiency case for *private ownership* of infrastructure is based on a number of premises which may or may not be correct.

Firstly, it assumes that the equity risks of the infrastructure project are largely commercial in character. But the equity risks are often more regulatory and political in character and in such cases the private sector is likely to demand a very high risk premium.

Secondly, the government is not always able to effectively transfer to the private sector the ultimate risk of default. Whatever the formal contracts might say, if a privatised hospital, school, road or railway network fails to perform, the government is held responsible.

Thirdly, private ownership is able to deliver benefits to users only if there is sufficient contestability in financial and service markets. The market for infrastructure finance has now matured and the up-front transaction costs such as fees to financial intermediaries, while still high, are now more reasonable than they were. But it remains hard to avoid quasi-monopoly market power in many infrastructure service markets. In such circumstances, privatisation would require close regulation and monitoring to ensure prices are reasonable and there is adequate accountability and transparency. This could nullify many of the efficiency advantages of private participation.

A fourth assumption is that private ownership will lead to improved managerial incentives. But will it? Government agencies are often derided for their lack of modern management expertise but in recent years they have developed ways to auction out community service obligations to avoid opportunistic political interference while also giving managers clear goals and well-structured performance incentives. There are many successful state-owned enterprises across the world, one example being Singapore Airlines. Private ownership of infrastructure, especially in listed companies, comes with its own problems such as the overriding desire to satisfy the short term demands of financial markets.

Finally, assigning infrastructure ownership risks predominantly to the private sector can lead to a misallocation of capital resources. For example, it tends to create a bias in favour of infrastructure investments with good commercial potential and against social infrastructure with high social returns (an issue I return to later). As well, in the case of new roads, privatisation can distort patterns of usage (forcing motorists to take less time-saving alternatives).

A recent OECD study of country experiences finds there are only 'limited' efficiency gains from extensive involvement by the private sector in the ownership and provision of non-self-funding social infrastructure and in social protection.[9]

In short, while private equity ownership of infrastructure will often be able to save taxpayers money and offer a service that is cheaper and more responsive to consumer preferences, governments should not start with a universal presumption that it is always superior to public ownership (which is what the embargo on net public borrowing implies). Each case needs to be assessed on its merit.

Fourth myth — that 'government borrowing for infrastructure investment puts upward pressure on inflation and interest rates'.

This view about the implications for interest rates and inflation is widely held, even by people who should know better, including the former Treasurer, Peter Costello.[10] Yet it has very little validity. Here it is important to distinguish between interest rate pressures stemming from capacity constraints ('real crowding out') and those stemming from financial market reactions ('financial crowding out').

If Australia's productive capacity is fully stretched, any new government infrastructure investment financed out of borrowings will, if other policies remain unchanged, add to inflationary and interest rate pressures — at least in the short term until the investment starts to pay off. However, against this, I would make the following observations:

1. on past experience, there is likely to be some longer term offsetting shift in private saving (e.g. through the so-called Ricardian equivalence' effects on anticipated future taxes) which will dampen the initial impact on demand of additional borrowing by about a third to a half (Comley et al 2002);
2. transferring financing responsibilities to the private sector will not help much to ease interest rate pressures since the short term effect on aggregate demand will be broadly the same; and
3. the fiscal authorities can avoid short term inflationary and interest rate effects by taking action to discourage or defer other types of national spending and by timing well the infrastructure investment program over the business cycle.

What of 'financial crowding out' — the risk that global financial markets will require an extra interest rate 'loading' for country and sovereign risk? This can happen in two ways. The first is by impacting on global capital markets, although this can be ruled out as Australia is a price-taker in these markets. The second is through effects on inflationary expectations. This has been a problem in the past because credit rating agencies tended to get skittish when a major new program of infrastructure investments was financed by public sector borrowing (rather than by private interests) because of unease about the lack of commercial and market disciplines in decision-making and the fear it might create useless 'white elephants' and make the additional debt hard to service. However, with public debt now at historically very low levels, and assuming new infrastructure decisions are made on the basis of sound cost-benefit evaluations, rating agencies and financial markets can be expected to take a more sensible and relaxed view of both public sector and external deficits.[11]

Fifth myth — that 'if a particular infrastructure project cannot be sensibly financed by the private sector, revenue can fill the gap'

Relying on current revenue to pay for the full cost of new social investment is not a sensible or viable alternative to government borrowing.

Firstly, we cannot count on a continuation of the extraordinary revenue windfall from the mining boom. When that boom ends, a federal government will have limited capacity to fund the up-front capital costs of infrastructure out of current revenue because of its self-imposed tax ceiling.

Secondly, there would be an economic cost if governments chose to crowd out economically desirable recurrent outlays (such as on education) or if workers were forced into higher than desirable effective marginal tax rates (Argy 2007 p. 149).

Thirdly, and most fundamentally, it is unfair to ask present Australians to pay upfront for new capital spending that will yield returns over a period of several years or even decades. Revenue should be used to pay for annual accrual expenses only (interest, depreciation, operational and maintenance costs).

Sixth myth — that 'there is no evidence that the fiscal straitjacket has impeded infrastructure investment'

This is an important issue because one of the key concerns of critics of the present fiscal straitjacket is that it has led to neglect of Australia's public infrastructure — and especially social infrastructure. To explore this issue further, I would ask two questions:

1. Is there hard evidence of neglect?

It is true that the evidence of infrastructure neglect is inconclusive, however, there is plenty of prima facie evidence — especially social and environmental — if one looks at:

- the steep relative decline in public investment over the last 15 years;
- the wide range of studies identifying specific infrastructure bottlenecks (such as coal ports in Newcastle and Dalrymple and electricity supply);
- cost-benefit studies pointing to high social returns from new investment; and
- opinion polling and anecdotal evidence of community dissatisfaction with the state of our infrastructure.

Public investment is lower today as a proportion of GDP than it was 15 years ago (in the late 1960s it was equal to one-half of private investment and today it is barely one fifth). This alone does not prove fiscal neglect. It may, for example, reflect such factors as more cost-based pricing (affecting demand), past over-investment in some areas and a shift from public to private financing. But the most marked decline has been in areas of social investment that do not lend themselves easily to private equity funding. It is also significant that the decline in public investment has been more rapid in Australia than in many other comparable countries.[12]

Sector-specific studies and anecdotal evidence reveal deficiencies in:

- economic infrastructure such as in power generation capacity, telecommunications, seaports and coal terminals;[13]
- social infrastructure such as pre and public schools, hospitals, urban roads, public transport, child care, training, lifelong learning institutions, community and preventative health care, domestic electricity supply, age and disability care and public housing; and
- environmental infrastructure such as water supply.[14]

In addition, there are many credible cost-benefit studies showing that social investments (especially in early childhood development and targeted labour market programs) yield high marginal social returns.

Finally, opinion polling shows a widely held and growing disenchantment with the standard of public services, especially in big cities and in regional areas, and a strong willingness to pay more taxes to improve the quality of services.[15]

All this is inconclusive but it is strongly suggestive of infrastructure neglect over the last decade.

2. Is the fiscal stance to blame for the apparent deficiencies?

Accepting that there are some infrastructure deficiencies, is fiscal policy to blame?

In my view, the deficiencies in economic infrastructure are more likely to be due to bad planning, poor management or tax disincentives than lack of finance. This is because such infrastructure can be readily financed by government trading enterprises (which have relative freedom to borrow and whose spending has held up fairly well) or by the commercial sector.

But there is little doubt that the fiscal stance is largely to blame for the neglect of social and environmental infrastructure (education, health, housing, transport, water and community amenities) because:

- such infrastructure does not lend itself easily to private financing as, typically, such projects are relatively complex, long lived and capital intensive, have long pay-back periods and seldom generate a steady cash stream sufficient to make them even approximately self-funding (paying for interest and depreciation);

- such infrastructure relies heavily on 'General Government' fixed capital non-defence spending, which has been declining relative to other investment (ABS 5204.0); and
- there is evidence of a trend decline in the share of non-cash government benefits going to the poor.[16]

As I will argue later, the fiscal straitjacket is creating an artificial bias against investments or recurrent government outlays of a social or environmental kind.

True, some of the gaps in social infrastructure supply are capable of being corrected by means other than new investment. For example, there may be a problem of misallocation of public capital (for example, relatively too much spending on roads and not enough on public transport) and there is certainly a need for pricing reforms to reduce demand in some areas (such as through congestion or carbon taxes). As the above discussion strongly suggests, the fiscal straitjacket has compounded infrastructure deficiencies.

Seventh myth — that 'running structural fiscal surpluses is good for national productivity'.

Unless one starts with the simplistic premise that 'governments always stuff everything up' (as some exponents of *Public Choice Theory* argue), the argument that fiscal surpluses boost productivity can be turned on its head.

As already discussed, the embargo on government borrowing tends to have efficiency costs because it overloads the tax burden in the early years and encourages governments to use private financing when it is not the optimal choice.

A more fundamental productivity cost of the present fiscal stance is that it artificially constrains the ability of governments to choose between social and economic infrastructure and between private goods and collective services, even when the latter offers relatively high marginal social returns. In particular, as noted earlier, it creates a bias in the allocation of capital against many types of social investment such as public schools, hospitals, urban roads and transport, child care development, training, lifelong learning institutions and community and preventative health care facilities.

Capital markets work very imperfectly. They have a tendency to ignore wider economic benefits for 'third parties' (benefits not directly captured by market transactions), such as effects on the environment, travel time, accidents, and the productivity of the unpaid household sector. And they tend to under-invest in merit goods such as health, education, job search, specific training and certain kinds of infrastructure (that crowd in private investment).

While government failure is also rife and needs to be allowed for, it is ideological bigotry to assume that governments are always incapable of correcting for market failures. A number of credible studies have found national economic returns (in terms of real incomes per head) of between $2 and $10 per dollar of government outlays on early childhood disadvantage and broader access to health, education, housing, public transport and improved urban freeways,[17] with gains coming in the form of a better educated and skilled workforce and citizenry; greater geographic and occupational mobility of labour; less waste of potentially successful entrepreneurs; higher employment participation rates; diminished health costs; lower imprisonment rates; less spending on welfare and juvenile delinquency; savings in commuting time; lower accidents and reduced pollution.

Cross-country studies show that governments (notably the Nordic countries, Ireland, the Netherlands and Austria) who choose to give relatively high priority to social investment have been very successful in reconciling high levels of social redistribution with good — or even superior — economic outcomes.[18]

There is another, more subtle, productivity bonus to be earned from increased social investment. It arises because of the signal it gives that governments are serious about achieving genuine equality of opportunity — where everyone can achieve their full potential irrespective of the circumstances of their birth. This positive perception helps to reduce the risk of a community backlash against further efficiency-driven economic reform.

Eighth myth — that 'the community prefers lower taxes and does not like the idea of governments borrowing'.

This proposition (although not a complete myth) is debatable. When Australians are simply asked if they want lower taxes, there will always be a majority saying 'yes'. But when they are asked to express a preference for lower taxes relative to additional spending on such things as health, education and the environment, the responses are much more positive for spending.[19]

On government borrowing, it is true that there is probably some public hostility. But this is because politicians misleadingly call it a budget deficit and equate it with bad management and higher interest rates. Australians would respond much more positively if:

- government borrowing were linked specifically to particular investment projects;
- the benefits (shorter commuting times, fewer accident risks, improved power availability and water quality, etc.) were clearly spelt out; and
- they were told that government borrowing for investment purposes is prudentially sound and that, if fiscal policy was well managed, it would have no adverse effects on interest rates.

The present fiscal stance poses a basic democratic problem: by setting arbitrary fiscal targets, governments are restricting their own ability to respond to the preferences and expectations of the community. Society is being prevented from exercising the full range of choices available to it.

Why the present fiscal stance needs a rethink

In summary, Australia has got itself into a fiscal straitjacket, which is open to six objections:

- it has no prudential rationale;
- it starts with an arbitrary presumption in favour of private financing and spending instead of looking at each case on its merit;
- it impedes the government's capacity to meet the nation's infrastructure needs;
- it creates a bias in the capital market against high-yielding investment in human capital (because social investment has relatively less access to finance from commercially oriented financial institutions and enterprises);
- it forces governments to adopt financing options that are economically less efficient;
- it denies Australians a genuine, well informed choice on the appropriate balance between public and private goods.

A policy stance that militates against public investment in infrastructure thus gets low marks for both social and economic efficiency as well as on grounds of democratic legitimacy. With Australia's public debt and tax levels at very low levels (historically and compared with the rest of the world) and with our social and environmental infrastructure perceived by most Australians to be in a state of neglect, it seems to be clearly in the national interest to relax the present fiscal straitjacket.

A proposed new fiscal stance

Instead of damning the States for their current modest borrowing programs, the Federal Government should be taking a lead role in developing, with the States, a set of national infrastructure investment priorities. Labor's idea of a national infrastructure audit is a good starting point.

As to financing, governments should continue to support viable private-public partnerships but, where the benefits of private involvement do not stack up, they should not rule out the alternative option of government net borrowing (or, what is effectively the same thing, drawing on the Future Fund) over the economic cycle — subject to a commitment to maintain or increase public sector 'net worth' in the medium term on an accruals accounting basis.

The Commonwealth should then use its increased borrowing capacity, as well as some of its windfall revenue from the commodity price boom, to make capital grants to the States earmarked for specifically agreed projects which meet the standard cost-benefit criteria. In the longer term, one hopes the imbalance in the federal system will be rectified and the states given more financial autonomy but there is no immediate prospect of that.

The government infrastructure spending program should be sensibly timed over the business cycle. If there is an expectation that the economy will continue to operate at full capacity for many years to come, fiscal action will be needed to defer other low priority spending (such as on middle-class welfare) and to discourage some forms of private consumerism.

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ENDNOTES

[1] No one denies the need for governments to set their budget strategy in a sustainable medium term framework (i.e. over the business cycle as a whole) because it is good for policy predictability, financial market stability and public accountability. The debate is about the precise medium term (structural) fiscal goals that governments should set for themselves.

[2] Paul Kelly, *The Australian* 2/6/07.

[3] State *public trading enterprises* are allowed to carry debt in the same way as private corporations and even *at the general government level,* some state governments are tentatively moving towards a fiscal stance that aims for a surplus *in the operational account* but which leaves some room for net borrowing for new capital expenditure. But total state debt levels are not expected to exceed four or five percent of state GDP over the next five years, compared with 25% in the early 1990s.

[4] Keating (2004) points to literature which finds that 'there is not much empirical evidence of taxation affecting the supply of labour or saving' (p. 29)

[5] Argy 2006, pp. 57-60 and 2007-2.

[6] The UK, for example, seeks only to keep the operational account in the black and borrows if it needs to invest in excess of its annual savings. The EU countries are bound not to exceed a cash deficit of 3% of GDP over the cycle.

[7] NSW, like most other states, has a high and rising net public worth.

[8] See for example, the comment by Standard and Poor that the AAA rating of NSW is not under threat 'because of its strong balance sheet' (Alan Wood, *The Australian* 24/2/06). Hugh Emy, in *Australian Fabian News* June 2005, observes that 'it is clear from comments by Standard and Poor that investment aimed at expanding long-run economic capacity is more likely to support than diminish credit ratings in the long run'.

[9] 'Should we extend the role of private social expenditure?' *OECD Social, Employment and Migration Working Paper* no. 23.

[10] Mr. Costello blasted the states for 'running deficits' (borrowing) because it would put upward pressure on interest rates. But in the same interview he said that he had 'no problem with bank financed private debt' (Marc Moncrief, *The Age* 8 June 2006).

[11] Two papers by Treasury officers (Gruen and Sayegh 2005 and Comley et al 2001) lend strong credence to the view that financial markets are more relaxed about an increase in government and external debt when public debt levels are low.

[12] Kamps (2006) shows that the government net capital stock as a percentage of GDP at 1995 prices was 19th lowest out of 22 countries in 2000 compared with a ranking of 11 in 1980. See also Hugh Emy in *Australian Fabian News* June 2005. If one assumes a stable relationship between the desired stock of capital and level of GDP, then in a period of accelerating economic growth, like the present, the ratio of infrastructure investment to GDP should be rising in Australia. It is only in the most recent year that public investment has taken off, driven by state government infrastructure spending.

[13] For example, in transport, much has been said of the problems of the Pacific Highway and the lack of an inland north-south rail freight link or corridor. Also there are concerns about coal supply bottlenecks such as the Dalrymple Bay terminal in Queensland (report by Adele Ferguson in *The Australian* 18/7/07).

[14] Argy 2006, chapter 4.

[15] Twenty-five percent of Australians don't have faith they would receive adequate hospital treatment if they had an accident, according to a recent Roy Morgan Research survey. See also Argy 2006, pp. 47 and 55.

[16] Sources: ABS *Household Expenditure Survey* (ABS 6537.0); Commissioned study by Victorian Government, *Shared Future* (2004) and analysis by Ann Harding in *The Australian* 25/2/02.

[17] See Argy 2006-2, pp.64-65. See also Abelson et al (2003) and Fitzgerald 2003. The Business Council of Australia commissioned a study in 2005 which estimated a $16 billion permanent increase in GDP from $90 billion spent on infrastructure — mostly economic rather than social. Research modelling by The Brotherhood of St Laurence indicates that every dollar of investment in community enterprises that tackle local, long term unemployment could yield societal benefits of $14 (Tony Nicholson in *Australian Policy Online* 12/09/2007).

[18] See Argy 2006-2. pp. 66-7 and 75ff.

[19] See sources in Argy 2006 p 58.