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Crippling Debt, Not Covid, Will Be The Legacy Of 2020

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Long after COVID-19 is gone and forgotten, Australians will have an expensive reminder of the disastrous year that was 2020. The legacy of the year of lockdowns will be the more than $1 trillion of Commonwealth debt which Australians, both alive and not yet born, have been saddled with.

From midday on 23 March 2020, Australians entered their first lockdown. Businesses were forced to close, hundreds of thousands of people were forced out of work or made to take pay cuts, elective surgeries were suspended, and school gates were bolted shut for almost all students.

Australia was about to enter its first recession in almost 30 years, and extraordinary government spending was implemented to, in the words of Prime Minister Scott Morrison, “build a bridge to the other side” of lockdown measures and the economic and social carnage which would ensue. The federal government announced a $100 billion wage subsidy, JobKeeper, which would maintain the relationship between employees and their employers through the lockdown and into the economic recovery. It was massive spending items like this, coupled with collapsing tax receipts, that led to the most rapid expansion of government debt in recent history.

Commonwealth debt as a share of gross domestic product shot up to almost 50% by the end of the financial year, building on the significant increase which came about after the global financial crisis. The Morrison government went from being on the cusp of delivering the first budget surplus since the Howard government to setting the record for the largest budget deficit on record.

It quickly became evident that younger Australians were going to be paying the price for this. Even those born in the second half of this century are likely to play their part paying off this extraordinary level of debt; an Institute of Public Affairs analysis of the 2020-21 Budget found that Commonwealth debt would likely not be eliminated until 2080.

Government debt has always imposed significant costs on current and future taxpayers, but as COVID-19 spread across the world and governments ramped up spending to pay for their disastrous lockdown measures, a number of commentators have insisted that government debt no longer matters. Australians will do just fine with a $1 trillion debt burden, they say, because interest rates are so low and, besides, we can actually get away with never paying the debt back anyway.

Prominent financial journalist Alan Kohler wrote in *The Australian* on 22 June 2020: “At least this pandemic might result in one good thing: the end of the notion that government deficits come from ‘reckless overspending’ and are a ‘burden on our children’, and have to be paid back with budget surpluses. They aren’t, and they don’t.”

And Professir Judith Bessant of RMIT University wrote in *The Age* on 11 August 2020 that “everything we thought we knew about public finance over the past 40 years is wrong”, and encourages the government to “release currency into the economy”.

Modern Monetary Theory (MMT), the latest fad in economics, supposedly provides the intellectual cover these commentators need to fire up the money printers and ignore deficits and debt. But there is actually nothing new behind MMT; governments have always had to pay off their debt one way or another, and firing up the printing press always ends in tears. As former Governor of the Bank of England Mervyn King outlined in *The Spectator* in December last year, “MMT is neither modern, nor monetaury, nor a theory.”

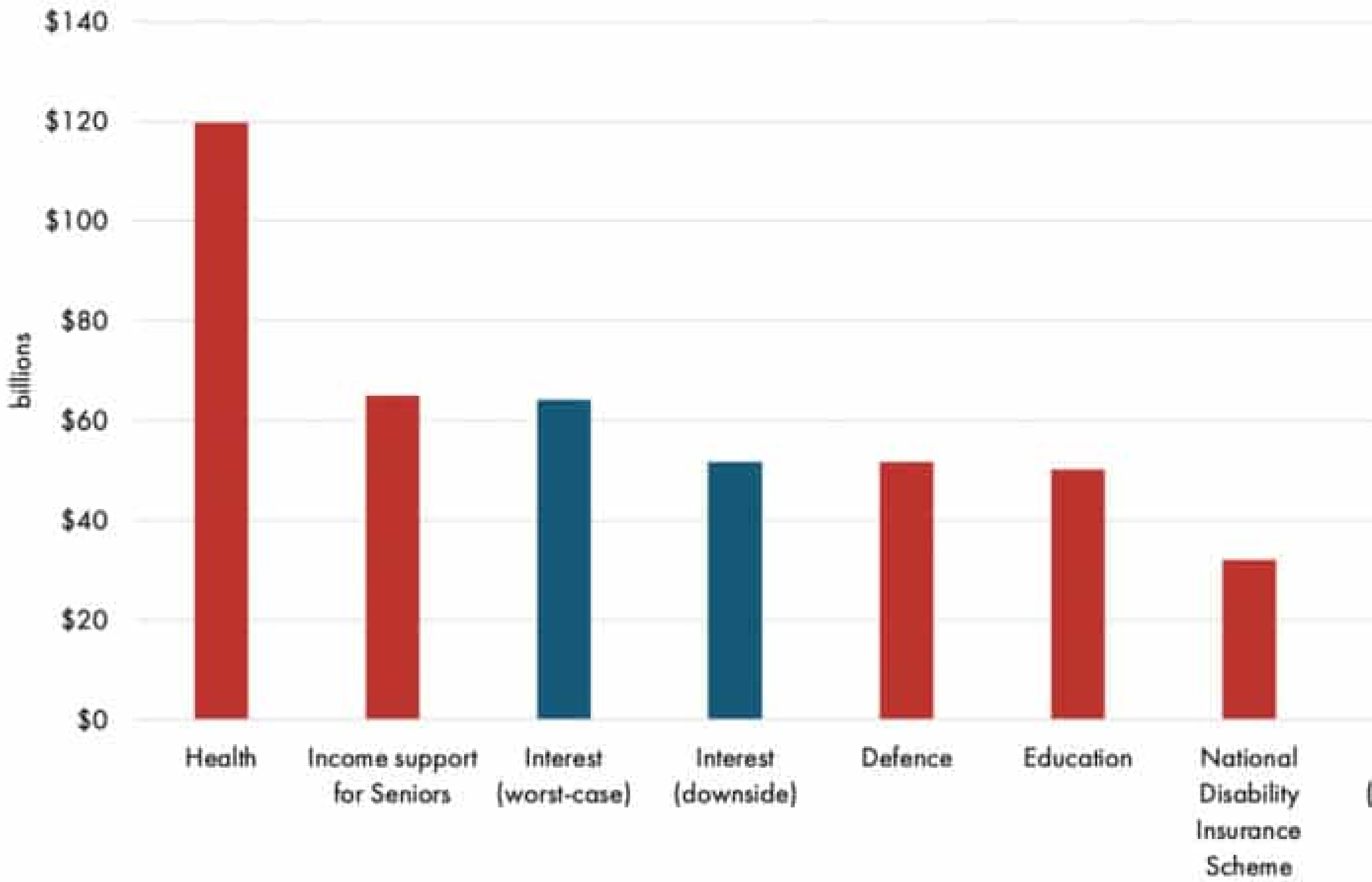
No matter what MMTers, as they are known, say, debt still matters. This was the subject of a recent Institute of Public Affairs research paper, *Selling Australia’s Future: Why government debt matters and how to return to surplus*. In the paper, Research Fellow Kurt Wallace and I outline how much debt Australia has accumulated and why it matters. In doing so, it provides a strong evidentiary basis to counter the argument abounding in the media for the past year that debt does not matter anymore.

Our report outlines five main reasons why this is the case.

Firstly, debt has to be paid off at some point. This means either higher taxes, or lower levels of government spending. This is, in effect, a transfer of wealth from future generations to current ones. And to those who say this transfer is between different generations of Australians, and therefore not an issue, it's worth looking at the Australian Office of Financial Management statistics which outline that non-Australian residents currently own 53.1% of Commonwealth bonds on issue.

Secondly, interest payments impose an ongoing cost on taxpayers until the debt is paid off entirely. Our report contains modelling of different interest rate assumptions, finding that the interest payment on debt could cost up to $64.1 billion in 2030-31 alone. This is based on a worst-case scenario where interest rates reach 6% in 2030. This is one of the key findings which demonstrates how wrong those arguing that debt does not matter are. While interest rates are low now, the problem arises when debt has to be rolled over in the future when interest rates are higher. And there is no escaping this; the Treasury outlines in the Budget that they expect interest rates to reach 2.9% by 2030, and if this is the case, according to our modelling, the annual interest bill will be $31.3 billion. If rates tick up sooner or rise higher, Australians will be in real strife.

The chart below, taken from the report, puts our modelled interest payment scenarios into perspective. Under the best-case scenario, based on Treasury's assumption that interest rates will reach 2.9% by 2030-31 (and no sooner), the interest payment on Commonwealth debt will cost as much as the entire National Disability Insurance Scheme. Under the worst-case scenario, where interest rates reach 6% in 2030-31, the interest bill will be the third-largest item in the Budget, behind only the entire health budget and roughly equivalent to all spending on income support for seniors.



Thirdly, funding government spending by issuing debt removes political restraint on wasteful spending. When spending is funded by taxing current taxpayers, increasing spending means increasing taxes, and taxpayers can express their frustration at the ballot box. The as-yet unborn Australians who will be paying off the current debt have no such democratic power.

Fourthly, issuing government debt puts upwards pressure on interest rates, which can crowd out private investment and negatively affect economic growth. Anyone who claims otherwise is stuck in 2020, and should look at how the yield on 10-year bonds has risen since November. In an effort to mitigate this effect, the Reserve Bank of Australia has expanded its balance sheet by over 70% since 2019 by buying up government bonds. If this monetary expansion leads to price inflation, the RBA may be forced to abandon their bond buying activity and allow interest rates to rise, which will further reduce business investment and harm all Australians with a mortgage.

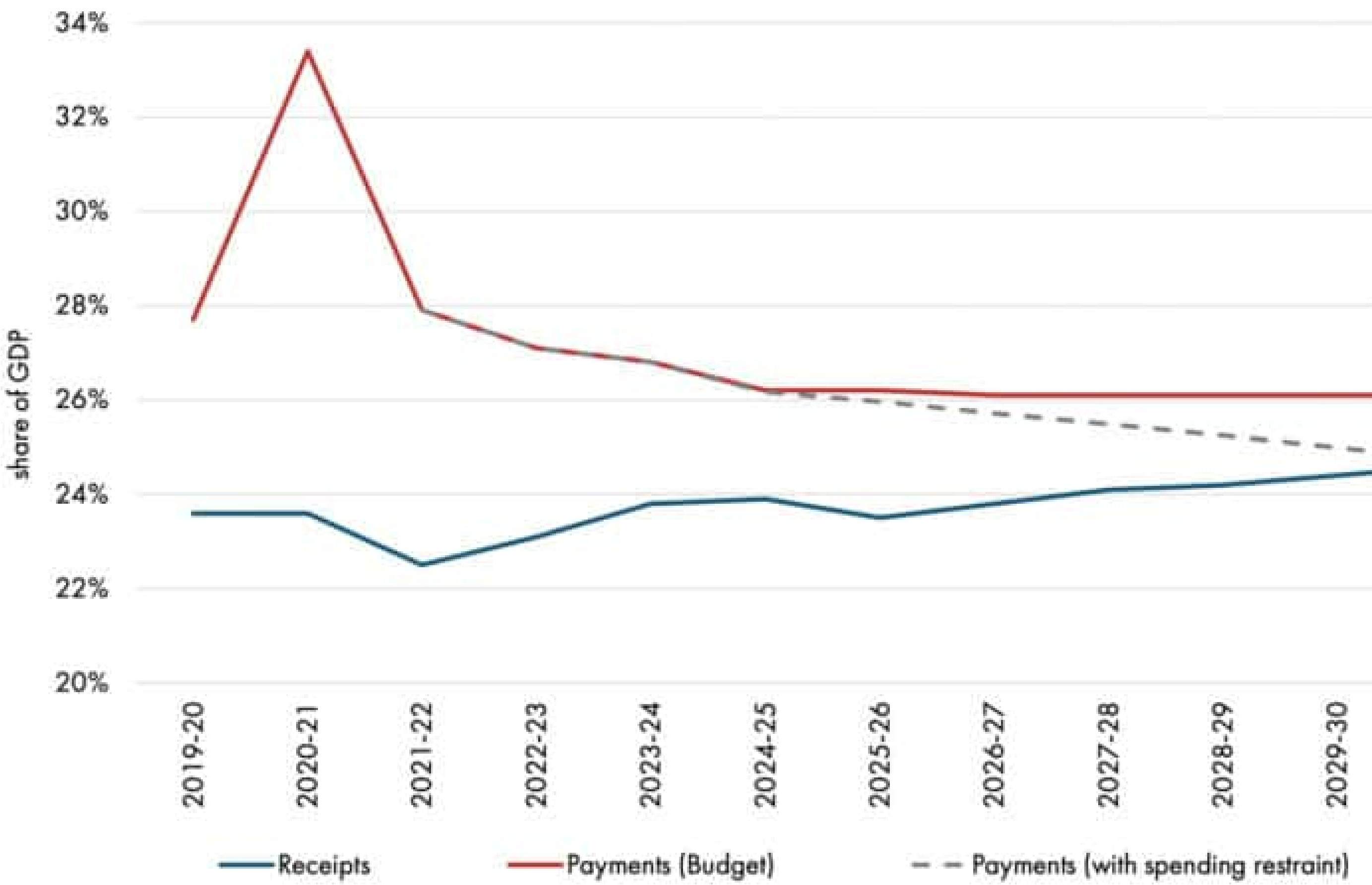
Finally, growing levels of debt can reduce overall economic activity by reducing the productivity of government spending, increasing uncertainty, creating an expectation of higher taxes in the future, and increasing sovereign risk. Our report highlights that in Australia, there is a link between growing levels of debt and economic growth: in years where debt is higher than it was 10 years ago, per capita growth is generally lower; and in years where debt is lower than it was 10 years ago, per capita growth is generally higher.

This last point is vital. Many commentators have falsely claimed that Australia's debt-to-GDP ratio is low by historic or international standards. This is misleading, however, as the *direction* of debt, not just the level, has an impact on economic growth. The report demonstrates that this link exists in Australia, and the decade of growing debt is likely causing a drag on economic growth. This can, in turn, cause a feedback loop where it becomes impossible to simply outgrow debt, higher taxes have to be raised to fund interest payments which causes a drag on growth and leads to calls for more government spending, which increases debt and further slows growth.

Put simply, debt matters. If we are to leave any semblance of prosperity for young Australians, then we need to prioritise paying down the national debt. This does not appear to be a concern of the federal government, with the Budget not even outlining a path back to surplus. An ambitious program of reduced spending, like the Premiers' Plan of the 1930s, will never be implemented by either of the major political parties. The Premiers' Plan was an ambitious agreement to, among other things, cut all non-adjustable government expenditure by 20% and restore confidence in the soundness of government finance and the banking system. At a campaign speech prior to the 1931 election, Joseph Lyons, explained that the Australian government should "avoid crazy schemes for the creation of unreal money," and that "the first contribution of the Government towards the restoration of confidence in the present and the future of Australia is to pay its way and to live within its income." Lyons' United Australia Party went on to win the election with 39 of 75 seats, and spent the next seven years as Prime Minister.

The federal parliament would benefit from Lyons' insights about creating unreal money and restoring government finances. But, as we outline in the report, the Budget can be returned to surplus within a decade without even reducing spending, much less an ambitious program on the scale of the Premiers' Plan.

Instead, the government must commit to modest spending restraint. The Budget forecasts spending to grow in nominal terms by an average of 5% per year between 2024-25 and 2030-31. If this growth was limited to an average of 4.1% per year over these seven years (excluding payments to the states and territories, making it an even more modest restraint), the Budget would be 'back in the black, and back on track' by 2031-32.



Before COVID-19 arrived in Australia, the Morrison government had just managed to turn a corner on Commonwealth debt. For almost a decade, the Coalition have been making the case for responsible fiscal management, and making very slow progress in implementing it, but over a matter of weeks their relatively more prudent plans were turned upside down and they quickly instituted the largest peace-time government spending program Australia has ever seen.

Australia's future prosperity now depends on reining in the budget deficits and quickly paying down Commonwealth debt. Interest rates most likely bottomed out in 2020, with the yield on 10-year government bonds rising since November, remaining above 1% for all but the first five days of 2021, and sitting at double what it was a year ago when lockdowns were first implemented. The costs of debt are real and varied, and perhaps most importantly it is those who do not get a say, who either cannot yet vote or who haven't even been born yet, who will be paying them.

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