Canberra’s debt problem

Where’s the money gone?

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Executive summary

- Public sector borrowing has been directed toward current consumption and transfers, harming our longer term growth prospects.

    - In real terms if federal general government infrastructure spending was fully funded by borrowing, there would have been an extra $129 billion in spending on roads, bridges, schools and hospitals from 2007-08 to 2013-14.

- The existing public debt load is not sustainable, according to an analysis of the latest budget positions, interest payments and economic growth rates.

    - Last financial year the federal government did not achieve the budget surplus necessary to stabilise its public debt trajectory in the long run.

- Interest payments on federal government debt are increasingly crowding out more efficient public spending, and already represent the seventh largest expense item in the budget.

    - Federal interest payments for the next financial year alone are equivalent to 14 times the ABC budget, four times the federal capital investment budget, three times the housing budget, or double the army capabilities budget.

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Australian governments are borrowing to spend on consumption and transfer payments, weighing down our economy

The federal government has been borrowing to fund some of its recurrent spending in recent years, violating principles of sound public finance.

Table 1 profiles trends in real commonwealth general government borrowing against infrastructure spending from 2008-09, the onset of the global financial crisis, to 2013-14. The information contained in the Table implies real infrastructure spending averaged a little over half of borrowing levels over the period.

If federal infrastructure spending over the last few years was fully financed by borrowing, Australians conceivably would have enjoyed the benefits of up to an additional $129 billion in infrastructure expenditure - including in the form of new roads, bridges, rail, schools, and hospitals.

Table 1: Trends in commonwealth borrowing and infrastructure spending

	Borrowing	Infrastructure spending	Infrastructure spending as share of borrowings	Additional infrastructure spending if fully funded by borrowing
	$bn	**$bn**	**%**	**$bn**
	(a)	(b)	(c)	(d)
2008-09	47.7	22.1	46.3	25.6
2009-10	51.0	26.0	50.9	25.0
2010-11	42.8	23.3	54.4	19.5
2011-12	43.6	24.3	55.9	19.2
2012-13	25.2	19.2	76.3	6.0
2013-14	55.7	22.4	40.2	33.3
Average			**54.0**	
Total	**266.0**	**137.3**		**128.7**

General government sector cash flow data for commonwealth government. Figures adjusted for price inflation (base 2007-08 = 100.0). Column (d) is the difference between columns (a) and (b), which may differ to figures presented in Table due to rounding. Borrowing refers to gross borrowing less the repayment of past borrowing. Infrastructure spending refers to net cash flows from investments in non-financial assets, plus imputed grants and subsidies for capital purposes (to commonwealth public corporations, other levels of government and universities, and private sector). Capital grants and subsidies for capital purposes estimated to account for 12 per cent of all grant and subsidy payments each year.

Source: ABS, Consumer Price Index, Australia, cat. no. 6401.0; ABS, Government Finance Statistics, Australia, 2013-14, cat. no. 5512.0.

There exist other pieces of evidence supporting the notion that most borrowings undertaken by government over the last few years have been spent for less productive purposes.

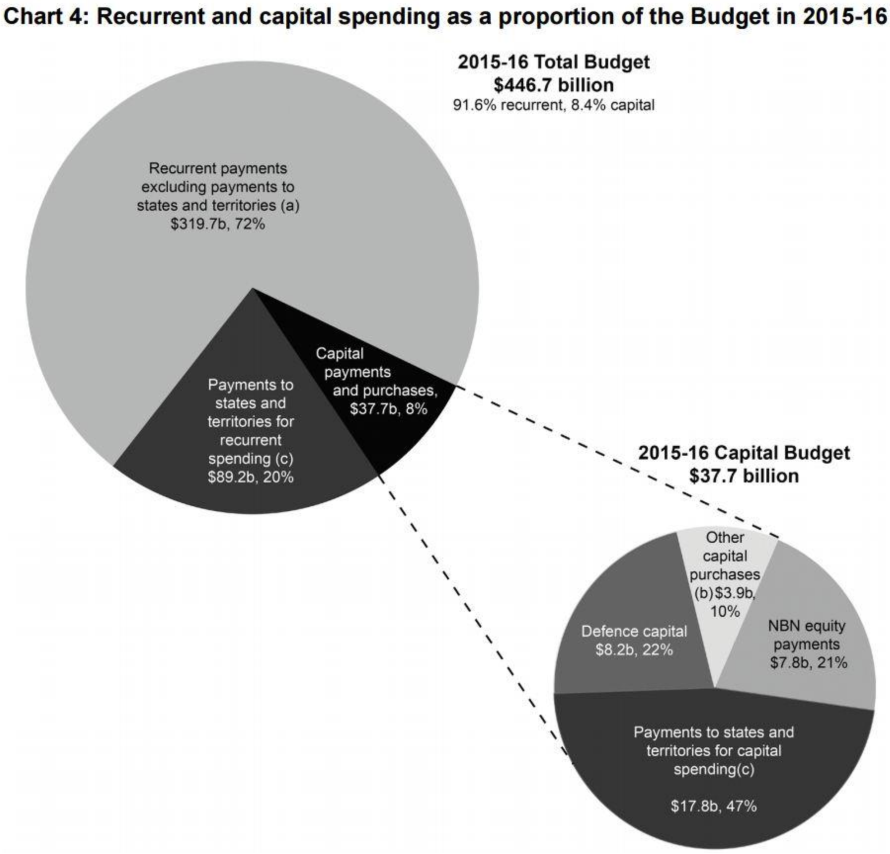
At the height of the 2008-09 global financial crisis the former Rudd government adopted an aggressive stance of discretionary fiscal policy in an attempt to avert an economic downturn. In so doing, it reversed the stance of its predecessor in maintaining relatively low gross indebtedness and, by 2005-06, a negative net debt position. In a telling passage in the Updated Economic and Fiscal Outlook statement, released in February 2009, the Rudd government justified a return to rapidly escalating debt as follows:

> 'The overwhelming majority of the increase in net debt is due to the collapse in tax receipts resulting from the deteriorating global economic outlook and the unwinding of the commodities boom.'[1]

Finally, a breakdown of commonwealth spending into recurrent and capital elements for 2015-16 reveals the composition of expenditure remains biased toward consumption and transfers (Figure 2). This implies, in turn, the majority of revenues raised by the commonwealth general government sector are used to primarily fund consumption expenditures and transfers (the latter mainly comprising welfare payments to individuals, and grants to lower levels of government).

[1] Commonwealth of Australia, 2009, *Updated Economic and Fiscal Outlook*, Statement by Hon Wayne Swan and Hon Lindsay Tanner, Canberra, p. 45.

Figure 2: Recurrent and capital payments, proportion of commonwealth general government sector budget



Source: Commonwealth of Australia, 2015, *Budget Strategy and Outlook 2015-16*, Budget Paper No. 1.

Now, if most federal general government revenues are used to fund recurrent spending and the government has substituted borrowing for taxation revenue, it logically follows that the bulk of increasing federal government borrowings were mainly directed towards activities other than for developing value-augmenting economic infrastructures (even accounting for capital transfers to state and local governments).

It is often argued that the efficacy of public debt is contingent upon the uses to which borrowed funds by governments are put. Specifically, if the debt is used to finance productive ventures that reliably yield a stream of economic or financial benefits over time, benefiting future generations, then a higher level of debt may be justifiable.

In contrast, a proposition that is almost universally accepted is that public sector consumption expenditures and fiscal transfers should not be financed through raising debt:

> 'To finance public consumption by debt is equivalent to the eating up of national capital value. By placing claims against future incomes, with no future offsetting benefit stream, we are lowering the capital value of that expected income stream. To state that even more dramatically, we are

> bequeathing negative capital value to future generations in our capacities as members of the body politic.'[2]

Notwithstanding continuing borrowing efforts to refinance existing commitments, it is not implausible, given the information previously mentioned, that much of the debt proceeds raised by government have been applied to non-capital areas of spending of prospectively lower value. Such practices harm our economic potential in the long run.

[2] James M Buchanan, 1987, 'Debt - An Economic and Moral Crisis', *IPA Review* 41 (1): 56-57, p. 56-57. It should also be noted there is a growing tendency by political representatives to label recurrent consumption and transfer payments as 'investments,' evoking the potentially misleading notion that each borrowed (or taxed) dollar government spends in beneficial.

Australia's debt trajectory is unsustainable not in the future, but right now

There have been growing expressions of concern that the trajectory of public debt is becoming unsustainable, making it difficult to manage debt repayments without significant cuts to spending or increases in revenue into the future.

As a recent paper by Tony Makin and Julian Pearce indicates,[3] whether or not the levels of debt owed by government are sustainable (as indicated by a stable debt-to-GDP ratio) depends on various factors:

- the existing amount of gross debt, since a larger debt amount at any given time contributes to a higher debt-to-GDP ratio which must be managed;
- the level of interest repayments on the debt, with higher servicing costs at risk of putting additional strains on the annual budget;
- the size of the budget balance (less interest repayments) itself, with deficit budgets in themselves contributing to the aggregate debt burden; and
- the growth rate of an economy, as stronger economic growth helps to reduce the debt-to-GDP ratio.

Using an empirical framework employed by Makin and Pearce we can find out if the public sector debt burden is sustainable, or unsustainable, by comparing the actual budget balance achieved by government versus the level of budget balance needed to stabilise the debt-to-GDP ratio.

If the actual value of the budget balance exceeds that value required for long run debt stabilisation, the debt-to-GDP ratio is falling and the government is on a sound path to manage its debt. This would tend to occur when the actual budget is in very low deficit or in a surplus position.

Contrasting this, if the actual budget balance is less than the stabilising value public debt ratios are rising and debt management becomes more difficult. All else being equal, an actual budget in a deficit position would not be one which stabilises the long run debt-to-GDP ratio.

Table 2 provides a comparison of actual and stabilising primary budget balances for the commonwealth general government sector and total public sector in 2013-14.[4] The federal government incurred a budget deficit which was too large to help return the debt-to-GDP ratio to stability.

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[3] Anthony J Makin and Julian Pearce, 2014, 'How sustainable is sub-national public debt in Australia?', *Economic Analysis and Policy* 44: 364-375.

[4] Total public sector categories include the multi-jurisdictional sector, comprising mainly higher education institutions.

Table 2: Actual versus stabilising commonwealth government budget balances, 2013-14

	Actual primary balance	Stabilising primary balance	Stable / unstable debt path
	% GDP	% GDP	
General government sector	-1.40	0.09	Unstable
Total public sector	-1.67	-0.10	Unstable

Basis for calculation provided in Anthony J Makin and Julian Pearce, 2014, 'How sustainable is sub-national public debt in Australia?', *Economic Analysis and Policy* 44: 364-375.

Source: ABS, Australian System of National Accounts, 2013-14, cat. no. 5204.0; ABS, Government Finance Statistics, Australia, 2013-14, cat. no. 5512.0.

With the 2015-16 Budget recently released by the commonwealth government, it is possible to present a preliminary comparison between the actual and stabilising budget balances for the general government sector in 2014-15 and 2015-16. This should provide us with some insight as to whether public debt has remained on a sustainable path.

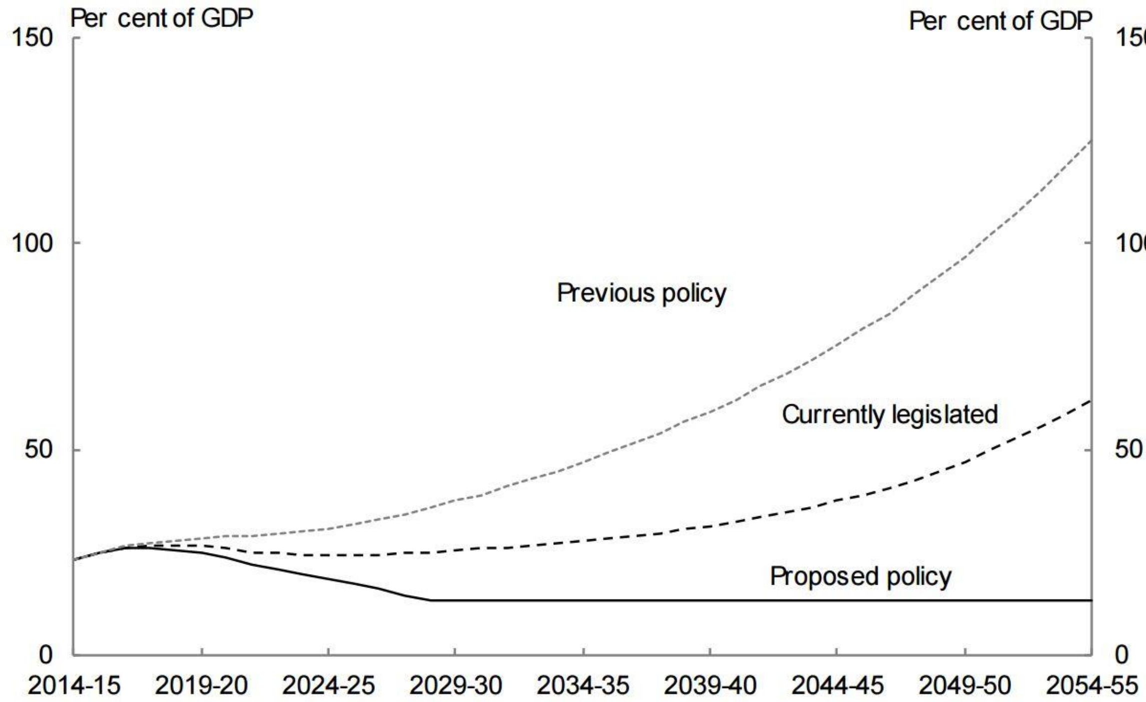
Using data from various sources, including national accounting data for economic growth rates, it is calculated that during 2014-15 the actual budget balance (a deficit equivalent to 1.7 per cent of GDP) was lower than the required budget balance for stability (a surplus equivalent to 0.5 per cent of GDP). For the following year, the actual budget balance (a deficit of 1.2 per cent of GDP) was lower than the stabilising budget balance (0.5 per cent of GDP).

In short, this analysis indicates that the commonwealth general government debt profile has transgressed onto an unstable growth path in recent years, and there is every expectation the problem will get worse without fiscal reform.

The latest Intergenerational Report (IGR) reports that if policies prior to the 2014-15 Budget were maintained (referred to in the IGR as the 'previous policy' scenario) the level of gross debt is projected to grow to about 125 per cent of GDP by 2054-55 (Figure 3). This burden of debt is inconsistent with notions of fiscal sustainability:

‘Without stabilising and reducing this debt, the ‘previous policy’ scenario shows that future generations will not only have to fund their own government services, they will be funding the services used by Australians today.’[5]

Figure 3: Long run commonwealth government gross debt projections



General government sector data. Projections assume trend economic growth of 2.8 per cent per annum from 2021-22 to 2054-55.

Source: Hon J. B. Hockey, 2015, *2015 Intergenerational Report: Australia in 2055*, Commonwealth of Australia, Canberra.

5 Hon J. B. Hockey, 2015, *2015 Intergenerational Report: Australia in 2055*, Commonwealth of Australia, Canberra, p. xix.

Interest repayments deprive taxpayers of public services and distorts fiscal decision making

Increasing indebtedness also raises the costs of interest payments to domestic and foreign holders of government-issued securities, reducing the capacity of government to fund services that are more valuable to the taxpayer.

It is estimated that gross interest payments by the commonwealth general government sector will be in the order of $15.6 billion (accrual basis) this financial year.[6] This amount represents the seventh largest expense payment by the government (Table 3).

[6] Net interest payments refer to the difference between interest paid and interest receipts.

Table 3: Top ten commonwealth government expenses, 2015-16

Program/expense	Amount ($ millions)
Revenue assistance to states and territories	57,749
Seniors' income support	44,178
Medicare services	21,141
Family Tax Benefit	20,152
People with disabilities income support	17,059
Public hospitals assistance to states	16,441
Interest payments	**15,561**
Job seekers income support	11,515
Residential and flexible care	10,161
Non-government schools support	9,997

Source: Commonwealth of Australia, 2015, *Budget Strategy and Outlook 2015-16*, Budget Paper No. 1.

The continuing payment of interest on debt represents foregone opportunities for government to finance other programs and activities that are more strongly demanded by the Australian community. The $15.6 billion gross general government interest bill on debt is, for instance, generally equivalent to:

- Over fourteen times the annual appropriations allocated to the Australian Broadcasting Corporation ($1.1 million in 2015-16).
- Over four times the annual foreign aid budget ($3.3 billion in 2015-16).
- Four times the budget allocated to net capital investments across the country ($3.9 billion in 2015-16).
- Almost three times the housing and community amenities budget ($5.3 billion in 2015-16).
- More than double the spending needed to enhance the capabilities of the Australian Army ($6.8 billion in 2015-16).

If the commonwealth government were debt free, it could return $15.6 billion back to the community in tax cuts reducing the average federal tax burden from 22.3 per cent of GDP in 2015-16 to 21.4 per cent.

Conclusion

Public sector debt is a problem for today for three key reasons:

- Borrowed funds are being used to fund subsidies and transfers, and not for building improved productive capacity in the long term;
- The growth in debt is presently on an unsustainable footing; and
- interest payments are increasingly crowding out essential public services.

Given the deteriorating position of our national public finances, corrective policies undertaken by all levels of government are now required to help reduce the overall debt burden. Indeed, the sooner that Australia's public debt problem is addressed the sooner that Australians can enjoy a more prosperous future.