The Fiscal Fiends Are Back

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THE Keynesians are on the war-path, demanding a return to budget deficits and borrowing. Paul Keating, formerly World's Greatest Treasurer, expressed the Keynesians' critique most colourfully at this year's CPA Congress:

> I inoculated a generation of treasurers with the surplus needle and none of them have found the antidote…They always want to run these budgets in surplus, whereas in fact what they should be doing is providing public infrastructure to lift our productivity. If we can keep our productivity up, we will keep the inflation rate, therefore interest rates, down.

In short, the critique is that governments have blindly committed to a debt-reduction policy and, as a result, are under-spending on long-lived public infrastructure investment which in turn is undermining the nation's productive capacity. The master blaster from the past is hardly alone in this view; he is supported—at least in principle—by such diverse groups as the Property Council, the Commonwealth Bank, the Australian Institute of Engineers, the Federal Labor Party and a good number of economists.

Do they have a case?

There is no doubt that governments have had a fundamental rethink about debt and infrastructure funding. The stock of public-sector net debt has been cut from $164 billion (34.9 per cent of GDP) in 1994–95 to $66.6 billion (8.8 per cent of GDP) in 2002–03—the lowest level of public-sector debt in the developed world. Moreover, this trend is likely to continue. Most governments plan to continue to reduce their overall debt levels into the future. Indeed, under current growth expectations, the Commonwealth plans to be debt-free in 2006–07 and the NSW Government by 2010.

In addition to reducing net debt, governments have also reduced their superannuation liabilities. All governments have sharply reduced the generosity of their public service sector superannuation schemes. All the States have now fully funded their newly accruing superannuation liabilities and, as a result, their unfunded liabilities will be extinguished over the next 30 years.

What gives rise to the change in debt preferences by governments?

The main reason for the debt-reduction programmes is simply money. The public sector is awash with funds and has no need to borrow.

A booming economy, combined with high effective tax rates, has generated a flow of funds to the public sector. Budget sector revenue has grown from 33 per cent of GDP in 1995–96 to 37 per cent in 2001–02. This translates into an additional $38 billion per year for the public purse. To put it in perspective, this is equivalent to another GST.

The Howard Government has been correctly chastised as a high taxer. Indeed, although down from its peak in 2000, its tax take remains higher than that levied by any other Australian government.

The States—the masters of the begging bowl—are also awash with funds. All States have expanded their taxing effort over the last six years, particularly on the booming housing sector. Moreover, the GST has proved to be what the Premiers always wanted—a super growth tax. Since 2000, GST revenues have grown at an annual rate of 9.3 per cent and GST payments to the States are currently (2002–03) about 30 per cent above initial forecasts.

The Carr Government stands out as the high-tax State Government. NSW's State tax take is easily the highest when measured on a per capita basis or as a share of the State's domestic product. The NSW Government also imposes the second-most onerous set of tax rates and conditions after South Australia.

Since 1995–96, budget sector revenue in NSW has increased at an average rate of 10 per cent per year. This translates into real per capita growth of around 6 per cent per year—a growth rate not experienced for at least 40 years.

Another reason for the change in debt preference is the reform dividend.

Since the late 1980s, Governments—both Labor and Liberal—have sold over $100 billion worth of operating businesses plus over $15 billion in land and other fixed assets. These sales were used, in part, to reduce net debt levels and thereby contributed to the lowering of the public-sector interest bill by roughly $6.9 billion per year.

Governments have also reformed their retained businesses, converting the PTE sector from net recipients of tax subsidies in the 1980s to net contributors to the public purse today.

Altogether, privatization and reform of PTEs have added around $9 billion per year to the public sector's bottom line in the form of lower interest, fewer subsidies and higher dividends and taxes. To put this into context, this reform dividend is equivalent to the combined capital works budget of the NSW and Victorian Governments for the current year.

Political leaders are also aware that the reform agenda of the past few decades has contributed greatly to the booming economy and their booming receipts. They are naturally loath to kill the proverbial goose that laid the golden egg.

They are also aware that an essential part of the reform agenda has been macro-economic stability and low interest rates, and are justifiably reluctant to undermine this by an unnecessary borrowing binge during a booming economy.

The question then remains: are debt-reduction polices resulting in an inadequate level of capital spending? Or, rather, is public-sector investment declining?

Taken on face value, the available data on capital formation (see Figure 1) indicate a decline in public expenditure of around 4.5 per cent of GDP since the late 1980s. Although not shown in Figure 1, the data also indicate that the decline in public sector capital formation has apparently taken place predominantly in the PTE sector.

The data are, however, biased; indeed the downward trend in public-sector capital spending is a statistical illusion and is widely known to be so.

As mentioned before, the public sector has sold $115 billion of assets to the private sector since the late 1980s. In the national accounts, from which the data in Figure 1 are obtained, assets sales are treated as a negative outlay (a reduction in capital spending) in the public sector and as a positive outlay in private sector. This means that about 40 per cent of the apparent decline in public infrastructure spending is a statistical illusion. In truth, the privatized assets have not only continued to operate, but have done so more productively in private hands.

The data are further biased downwards by the way in which public-private partnerships and capital spending by privatized business are treated. Over the last decade and more, a sizeable and increasing proportion of infrastructure spending, which in the 1980s would have been undertaken by the public sector, has been undertaken by the private sector. This includes roads, communication facilities, power generation facilities, ports, pipelines, hospitals, rail lines and rolling stock, government offices, vehicle fleets, computer facilities, stadiums, laboratories, etc. Indeed, in many States, the private sector is now responsible for the bulk of 'public' infrastructure.

The data required to correct for private provision of 'public infrastructure' are simply not available. Nonetheless, it is clear that once the data on public capital formation (Figure 1) are adjusted for assets sales and private provision of 'public infrastructure', public infrastructure spending would not show a declining trend and may well be increasing.

This view is supported by trends in NSW. Unlike the southern and western States, the NSW Government has privatized few businesses and therefore its capital works programme is relatively unbiased by ownership changes. NSW is also the State most criticized by the Keynesians for allegedly slashing infrastructure spending. The truth is that capital spending by the NSW public enterprise sector is approaching a 30-year high and is 77 per cent higher than the level recorded in 1995–96. This is being achieved in spite of an active public-private partnership programme.

In short, the reduction in debt has not had a deleterious effect on the level of investment in public infrastructure.

Keating and his fellow Keynesians make another faulty assumption, namely, that spending on infrastructure necessarily adds to the nation's productive capacity.

Clearly, publicly driven infrastructure can add to the nation's productive capacity and yield a high social return, but only if it is well-targeted and rationed. However, taking money away from other productive purposes to fund politically determined white elephants, such as the Darwin to Alice Springs railway or the Multifunctional Polis, undermines productivity and costs us dearly. And there is a cornucopia of wasteful and dud investments currently on governments' books.

The Keynesians also overlook the fact that using existing infrastructure better often yields higher returns than building new facilities. This was shown most starkly in the case of the Hazelwood generation facility in Victoria. Under government ownership the plant was slated to close and be replaced in 2004. Under private ownership it increased its productive capacity by 25 per cent and is expected to continue operating for at least another 30 years.

In summary, Keating and his Keynesian mates are once again wide of the mark—both on the fiscal facts and on policy prescriptions. Some people simply do not change or learn.

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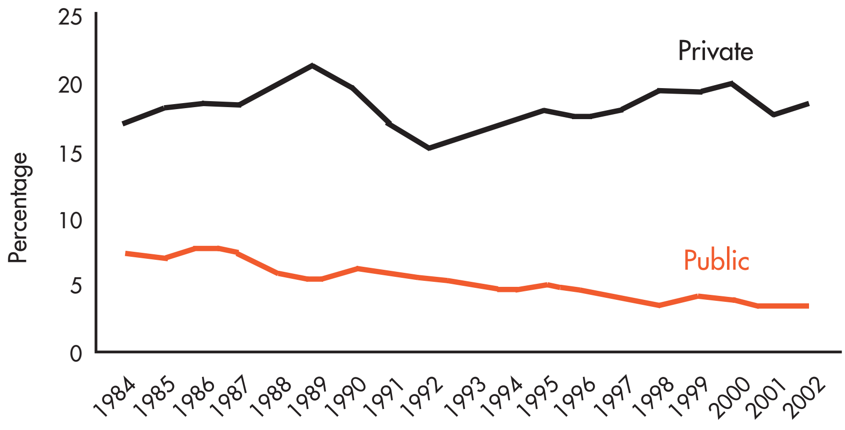
Figure 1: Government/Private Capital Formation, Proportion of GDP, 1984–2002



Source: The Allen Consulting Group, derived from ABS Cat. No. 5220.0