Robbing Peter tomorrow to pay Paul today: Why Australia's public debt is a problem

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Executive summary

- Australia has a pressing public debt problem, and this problem needs to be curtailed by dramatically reducing the size of government.
- Existing levels of public sector indebtedness across all three levels of government are not sustainable, according to an analysis of budget positions, interest payments and economic growth rates.
- Last financial year the federal budget deficit was not at the surplus levels necessary to ensure a sustainable public debt trajectory in the long run, and similar issues apply at the state and local government levels.
- The composition of government spending suggests that most public sector borrowing has been directed toward current consumption and transfer payments, which reduce the long run accumulation of productive capital and harm our growth prospects.
  - Growth in federal general government borrowings since prior to the GFC ($296 billion over seven years) has vastly exceeded growth in own-purpose gross capital spending by the commonwealth, and capital transfers to the state-local public sector and other bodies ($9billion).
- Interest payments on federal government debt are increasingly crowding out more efficient avenues for public spending, and already represent the seventh largest expense item in the budget.
- Federal interest payments for next financial year alone are roughly equivalent to fourteen times the ABC budget, four times the federal capital investment budget, three times the housing budget, and double the army capabilities budget.
- Resolving Australia's public debt problem needs resolute reform action by all levels of government, including spending restraint, privatisation, strong economic growth, and more resilient fiscal rule settings.

1 Introduction

One of the great controversies in Australian politics today concerns the answer to the following question: do we have a public debt problem on our hands?

Answering this question has assumed some degree of urgency in recent years. Stubbornly excessive spending since the 2008-09 global financial crisis has directly contributed to budgetary pressures faced by all levels of government. As a result, these pressures, evident in the observed multiple-year budget deficits, have spilled over in the form of rapidly growing public sector debt burdens.

It is estimated that during this financial year commonwealth general government gross debt will be in the order of $370 billion, or 23 per cent of GDP,[1] and this does not include the burgeoning debt commitments of commonwealth government enterprises, state and territories, local governments, and the higher education sector. The available statistical evidence suggests gross debt in Australia has been growing at among one of the fastest rates in the developed world.[2]

There are generally two schools of thought concerning whether the accumulated public debts owed by taxpayers, through commonwealth, state, and local governments, are budgetary and economic problems.

One strand of argumentation asserts that Australia's public sector debts are not burdensome and, if anything, should be further increased. In this context the much higher burden of debt of many other OECD member countries is invariably cited, whilst others have suggested that the present climate of very low interest rates provides an opportunity for governments to rapidly increase their borrowings.[3]

In contrast there have been several economists, media commentators, and political figures expressing their reservations about the growth in public debt, and the uses to which borrowed funds have been put by governments.[4] Those raising concerns about the ramping up of debt burdens in recent years have, accordingly, advocated remedial policies to ensure a return to sound budgetary management of Australian public finances.

This paper examines the key dimensions of Australia's public sector indebtedness, and identifies that we presently have a public debt problem requiring urgent redress.

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

Public debt allows expenditure for public goods and services to be tethered from contemporary aggregate tax collection constraints to fund them, thus allowing for the smoothing of public sector provision over time. Nonetheless, it is vital that the accumulation of debt by governmental authorities be conducted with due deference to the ability of individuals and businesses, in their capacities as taxpayers, to absorb the resultant financial obligations imposed upon them.

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[1] Commonwealth of Australia, 2014, *Mid-Year Economic and Fiscal Outlook 2014-15*, Appendix D: Historical Australian Government Data.

[2] Adam Creighton, 2014, 'In truth: our debt growth faster than Europe's', The Australian, 17 May.

[3] Peter Martin, 2015, 'Scaremongering about government debt is not helping; borrowing more might', The Age, 24 February.

[4] Tony Makin, 2009, Submission to Senate Stimulus Inquiry; Tony Makin, 2014, 'Rising public debt and the great austerity myth in the post-GFC era', The Australian, 12 December.

An unsustainable burden of public debt, in particular, risks magnifying the long term economic costs of debt accumulation. This is manifest through the crowding out of productive investments by the private sector as upward pressure upon interest rates are exerted, and the diminution of export opportunities as rising interest rates encourage capital inflows and, through it, currency appreciation.

Increasing public debt burdens may also prove unsustainable if they serve to impose a much greater burden of distortionary taxation upon productive economic agents, in order to service the debt obligations.

Of course, given the inherent incentive within majoritarian democracies for politicians, bureaucrats and vested interests to favour spending over taxing there is a particular need to guard against persistent budget deficits which led to an accumulation of public debts that future generations of taxpayers may find difficult to repay.

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

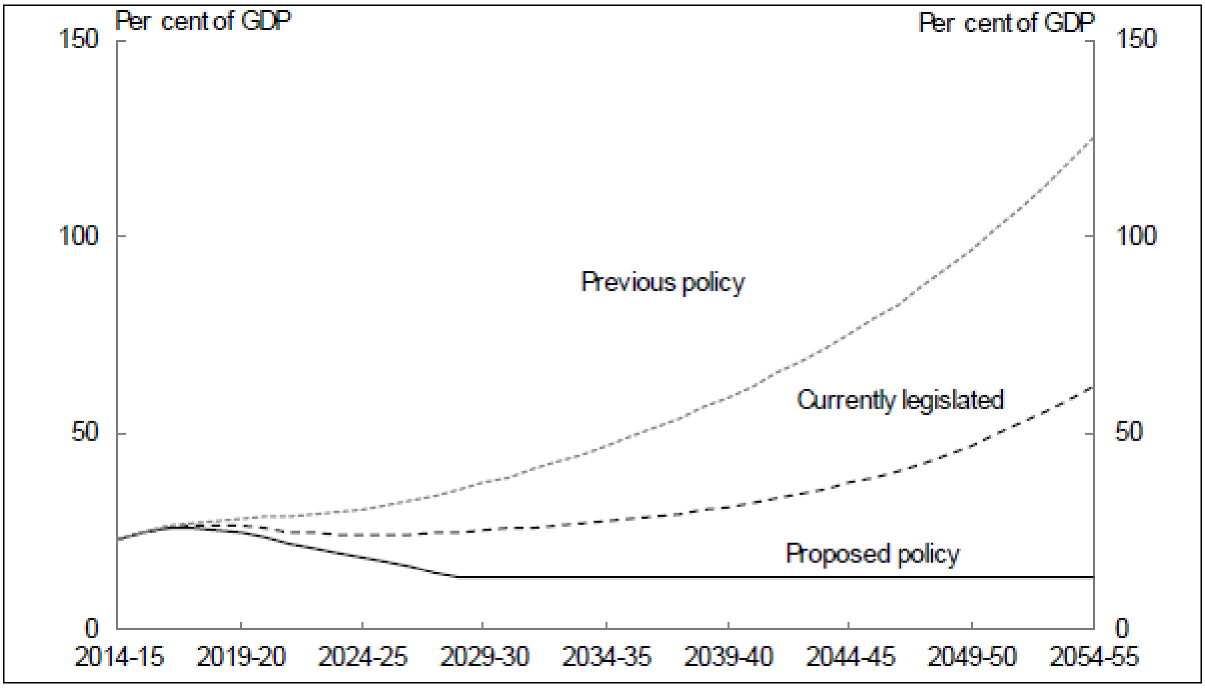
The latest Intergenerational Report (IGR) reports that the commonwealth government has a gross debt of approximately $360 billion, or equivalent to about 22 per cent of GDP. If the policies set in place prior to the 2014-15 Budget were maintained (referred to in the IGR as the 'previous policy' scenario) the level of gross debt is projected to grow to about 125 per cent of GDP by 2054-55. 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]

The debt burden scenarios presented in the IGR are presented in Figure 1.

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

Figure 1: 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.

Some commentators, often predisposed, it might be said, to the notion of extending the role of government in Australian economic and social affairs, have sought to lampoon the idea that the burden of our public indebtedness is getting out of hand.

A common refrain is that current levels of public debt are low both by international, and by our own historical, standards, and thus no cause for concern,[6] whilst others dismiss debt sustainability warnings presented in the IGR by contending, and not without justification, that it is impossible to accurately predict economic and fiscal developments many decades into the future.[7]

What these critics, and perhaps the government itself in some respects, tend to overlook is that the Australian debt burden is unsustainable not in decades from now, according to the projections, but is unsustainable today.

Abstracting away from seigniorage, or the capacity of government to effectively attain revenue by printing money, the capacity of governments to stabilise their debts (relative to the size of the economy) depends upon the size of gross public debt, the servicing cost of that debt, and the size of the primary budget balance (defined as the fiscal cash balance less interest payments).

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[6] Philip Soos, 2013, 'The truth behind our 'dangerous' public debt levels', The Conversation, 11 April; Greg Jericho, 2014, 'Is Australia's government debt really as bad as Tony Abbott claims?', The Guardian Australia, 9 June.

[7] Callam Pickering, 2015, 'Intergenerational Report: Too political and full of implausible numbers', Business Spectator, 5 March.

The primary budget balance, in itself, is an important estimate in public debt stabilisation analysis because it, in part, influences the rate at which public debt accumulates. If the actual value of the primary budget exceeds that value required for long run debt stabilisation, public debt ratios are falling; if the actual value is less than the stabilising value, public debt ratios are rising.

Makin and Pearce provided estimates of actual and stabilising budget balances, for the state general government and total public sectors which applied in 2012-13 (the latest available year of published government finance statistics from the ABS).[8] The authors found that no state had achieved a primary budget setting for long run debt stability at the general government level, with only NSW and Tasmania on a sustainable debt path with respect to their total public sectors.

Table 1 complements the estimates provided by Makin and Pearce by providing information about actual and stabilising primary budget balances for the commonwealth, state, and local general government and total public sectors in 2013-14.[9]

Table 1: Actual versus stabilising primary budget balances, 2013-14

	Actual primary balance (% GDP)	Stabilising primary balance (% GDP)	Stable / unstable debt path
General government sector			
Commonwealth	-1.40	0.09	Unstable
State	0.15	0.16	Unstable
Local	-0.09	0.01	Unstable
Total	-1.72	0.27	Unstable
Total public sector			
Commonwealth	-1.67	-0.10	Unstable
State	0.24	0.20	Unstable
Local	-0.09	0.00	Unstable
Total	-1.94	0.33	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.

Looking at the general government sector in the first instance, all levels of government combined (i.e., commonwealth, state and local general governments) have incurred actual primary budget deficits which are insufficient to return public debt to a stable growth trajectory. Similar results were found at each level of government.

Assessing the situation for the total public sector (incorporating government owned financial and non-financial enterprises), we find that the actual primary budgets at all levels of government, and

[8] Anthony J Makin and Julian Pearce, 2014, 'How sustainable is sub-national public debt in Australia?', *Economic Analysis and Policy* 44: 364-375. The general government sector refers to core agencies and departments primarily funded by taxation, whilst the total public sector includes general government entities and bodies which provide goods and services largely on a commercial basis.

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

for the composite of commonwealth, state, and local public sectors, are inconsistent with the objective of attaining a stable public debt.

It is also important to note that, after taking into account the financial activities of the likes of NBN Co., Australia Post, and the Australian Rail Track Corporation, among other entities, the actual primary balance of the commonwealth total public sector was also worse than that needed to stabilise debts.

With the 2015-16 Budget recently released by the commonwealth government, it is possible to present a preliminary comparison between the actual and stabilising primary 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 primary 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 (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 is likely to keep doing so without remedial policy actions.

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

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 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, debt financing of activities that do not yield sufficient benefits are widely seen as inappropriate.

Most economists tend to agree that governments should legitimately finance lumpy capital expenditures, such as economic infrastructure, by borrowing from domestic and international capital markets, rather than relying upon taxation revenues. This is because it is conceived that infrastructure tends to yield returns (in the guise of rising incomes and improved productivity performance) that more than match the principal and interest on the debt raised.

In practice, even if most of the funds borrowed by governments were directed toward capital works it does not necessarily follow that all implied public expenditures would automatically enhance long run productivity:

'The link between public infrastructure or capital spending and capital stock accumulation, and hence long-run growth, ... is often undermined by the low efficiency of public investment. The notion that public investment spending is equal to capital accumulation rests on the assumption that public investment is inherently productive. This assumption is particularly problematic, as poor project selection and a high degree of inefficiency and waste can distort the impact of public spending on capital accumulation, leaving a trail of poorly executed and ineffective projects.'[10]

The productive potential exuded by debt-financed infrastructure may also be compromised by union and other influences which inflate project costs, and, further, the quality of project cost-benefit analyses are often patchy, if undertaken at all.

Although the extent to which government finances what kinds of infrastructure projects via debt will continue to be debated, a proposition that is almost universally accepted is that public sector consumption expenditures and fiscal transfers should not be financed through raising debt. Writing in 1987, the late Nobel Prize winning economist James Buchanan depicted the economic implications of political initiatives to fund non-investment activities in the following manner:

'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.'[11]

It should be noted there is a growing tendency by political actors to conflate recurrent consumption and transfer payments as 'investments,' even though the latter necessarily entails a deferral of immediate benefits to politically-designated beneficiaries. The inclination to increasingly depict all spending as investments evokes misleading images that each borrowed (or taxed) dollar government spends is beneficial, and that borrowing (or taxation) should be maintained, or even increased, to propagate and entrench non-capital expenditures.[12]

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.'[13]

A breakdown of commonwealth spending into recurrent and capital elements for 2015-16 is illustrated in Figure 2, but, generally speaking, this expenditure composition biased toward consumption and transfers reflects a longstanding trend in federal public finance spanning years, if not many decades. This implies, in turn, the majority of revenues raised by the commonwealth

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[10] Era Dabla-Norris, 2014, 'Discussion', in Alexandra Heath and Matthew Read, eds., *Financial Flows and Infrastructure Financing*, Reserve Bank of Australia, Sydney, p. 136.

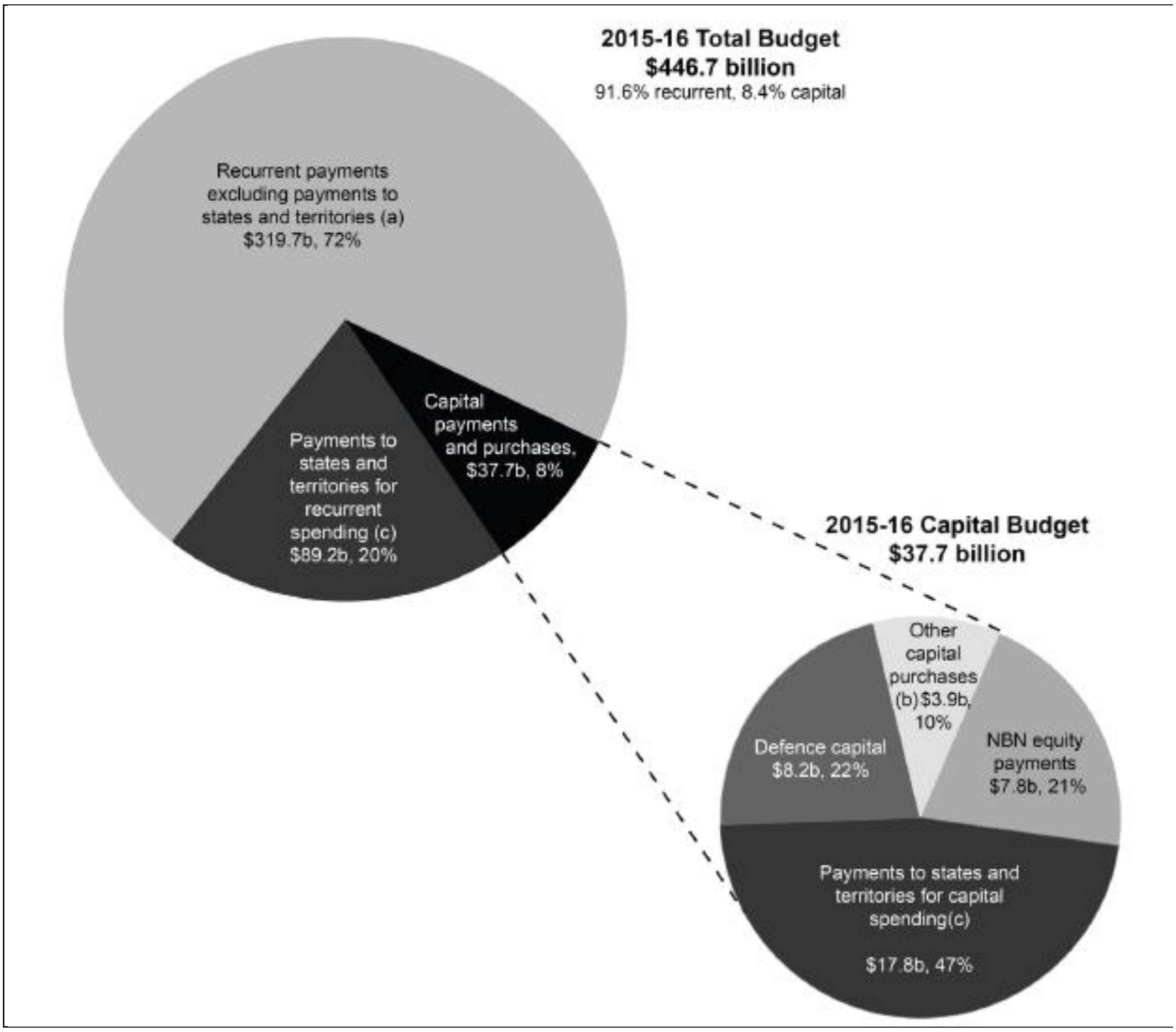
[11] James M Buchanan, 1987, 'Debt - An Economic and Moral Crisis', *IPA Review* 41 (1): 56-57, p. 56-57.

[12] Mikayla Novak, 2013, 'Defining investment in the federal budget', ABC Drum online, 20 May.

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

general government sector are used to primarily fund consumption expenditures and transfers (especially welfare payments to individuals, and grants to lower levels of government).

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



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

If most general government revenues are used to fund recurrent spending, and the government substituted borrowing for taxation revenue, it logically follows the bulk of increasing government borrowings, certainly at the commonwealth level, were possibly mainly directed toward activities other than for developing value-augmenting economic infrastructures (even accounting for capital transfers to state and local governments).

The proposition that the Australian public sector have written down their balance sheets to bolster recurrent, lower value spending is further underlined by the fact that direct capital expenditures by government, as a share of overall economic activity, has tended to decline over time, due to the considerable degree of privatisation that has taken place from the 1980s.

Underlining the points mentioned here, the latest ABS Government Finance Statistics indicates that borrowing by commonwealth, state, and local general government sectors increased by about $402 billion from 2007-08 to 2013-14. By contrast, gross fixed capital formation (that is, investments excluding adjustments for depreciation and similar variations) increased by about $14 billion over the same period.[14]

Examining commonwealth general government finances using the same statistical source, it can be shown that federal borrowing rose by about $296 billion from 2007-08 to 2013-14. This change in borrowing levels vastly exceeded the increases in federal own-gross fixed capital formation (about $2 billion over seven years) and capital transfers to other levels of government and other bodies (about $7 billion).

Similar trends were evident when assessing financial changes across the total public sectors of all levels of government. Total public sector borrowing rose by about $464 billion from prior to the GFC, whereas gross spending on non-financial capital assets grew by only about $4 billion.

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 Australian governments have been applied to non-capital areas of spending of prospectively lower value.

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

Putting aside the dispensation of borrowed funds by the public sector there is the concern that increasing indebtedness raises the costs of interest payments to domestic and foreign holders of government-issued securities.

In the most immediate sense the growth in interest costs on debt reduces the capacity of government to fund other services that are more economically valuable and/or that taxpayers demand.

To illustrate how interest on public debt financially deprives taxpayers of services and payments, consider that gross interest payments by the commonwealth general government sector are estimated to be in the order of $15.6 billion (accrual basis) this financial year.[15] This amount represents the seventh largest expense payment by the government (Table 2).

[14] ABS, Government Finance Statistics, Australia, 2013-14, cat. no. 5512.0.

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

Table 2: Top 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
Pharmaceuticals and pharmaceutical services	9,770
Public sector superannuation	8,187
Carers' income support	8,107
Child care fee assistance	7,261
Army capabilities	6,779
Commonwealth Grants Scheme (higher education)	6,653
Private health insurance rebate	6,341
Fuel tax credits scheme	6,230
Government schools support	5,746
Parents' income support	5,703
Air force capabilities	5,546

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

It should be noted that credit ratings assigned to government debt have an effect on the borrowing costs of new and maturing debts, with a credit rating downgrade raising interest payments ultimately borne by taxpayers. For example, it had been estimated the loss of Queensland's AAA credit rating under the Bligh government in 2009 increased interest costs on debt by 0.4 per cent (or $200 million) alone.[16]

Even putting aside the basic notion, once famously outlined by economist Milton Friedman, that public sector agencies cannot spend other people's money more effectually than individuals spend their own, governments are obliged to account for interest payment calls made upon the budget. Other things being equal, these financial obligations effectively reduce, at least at the margin, the degree of discretion policymakers can exercise in amending expenditure settings as circumstances change.

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 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).

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[16] Darrell Giles and Kelmeny Fraser, 2009, 'Queensland's AAA credit rating loss costs millions', The Courier-Mail, 21 February.

- 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

Despite the soundings of the pro-debt protagonists Australian public sector debt is already on an unsustainable footing, borrowed funds are likely being used to fund payments that present generations are consuming today (rather than building up improved productive capabilities for tomorrow), 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.

The most responsible measures in this regard would include a mix of significant recurrent expenditure reductions, privatisation of government assets, and a stronger focus upon promoting economic growth through unleashing the forces of market-tested betterment (rather than government subsidies and preferential regulatory treatments). Reinvigorated public debate is also needed with what rules and institutions are necessary to give politicians incentive to credibly maintain sound financial management of a public sector managed on behalf of citizens and taxpayers.

The sooner that Australia’s public debt problem is addressed the sooner that Australians can enjoy a more prosperous future.