ARTICLE

Budget 2008: the case for deep spending cuts

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DESCRIPTION

Today Macroeconomics.com.au released the April 2008 edition of our Commonwealth Budget Bulletin, in which we argue for the necessity of spending cuts. To make the case, we resorted to some ancient history. In 1988 a Labor government faced with a negative terms of trade shock, a huge budget deficit and a strong economy cut public spending by 2.3 per cent of GDP in the budget year. In 2008, another Labor government faced with a positive terms of trade shock, burgeoning inflation, and a strong economy should cut public spending by at least 1.5 per cent of GDP and cajole the states to make a further 1 per cent of GDP in savings.

The Howard government undertook a massive discretionary easing in budgetary policy from 2001-02, adding up to around $27 billion in new measures, on average, each year. The bulk of the loosening occurred from the 2004-05 budget onwards - totalling around $150 billion. All this spending was thrown at an economy in the mist of a commodity boom. Blind Freddy could have told you the outcome would be inflation. Throwing a huge stimulus at an economy lacking idle capacity and facing supply-side constraints was clearly inappropriate. This spending fever was overseen by senior ministers and endorsed by senior officials, who publicly lauded the achievements of the medium term fiscal strategy without making a well timed comment on the spending track record.

The sheer volume and poor quality of spending has contributed to bottlenecks in the economy, crowding out resource flows to productive sectors. Irresponsible budget policy and administration has contributed to higher prices and higher interest rates. An "easy" fiscal policy implies that monetary policy is tighter then necessary. We estimate that the $25-30 billion structural deterioration in the budget position of Australian governments since May 2002 is responsible for the 300 basis points (or 3 percentage points) tightening of monetary policy. Already the Reserve Bank has raised official interest rates by 75 basis points since the last election and we anticipate two further 25 basis point increases in June and October this year before the current tightening cycle comes to an end.

The Rudd government has been slow off the blocks on macroeconomic management and has struggled to find a consistent narrative to portray its intent and reasoning. This is contributing to the lack of coordination in macroeconomic policy management evident is recent months and has seen the entire stabilisation burden of macroeconomic policy fall to monetary policy.

The trade-off is simple.

• Option 1: Easy fiscal and tight monetary policy resulting in higher interest rates today and lower growth in 2008-09 and 2009-10.

• Option 2: Tight fiscal and easy monetary policy resulting in lower interest rates today and higher growth in 2008-09 and 2009-10.

The political honeymoon afforded to a new government provides a window of opportunity for bold reform, but it will soon be over. By budget night 2008, the bureaucracy will have wasted almost six months for net discretionary policy savings of less than $6 billion, delaying the necessary fiscal consolidation. It may be that deferring the pain now will contribute to a larger downturn later down the track. The aim of the game of fiscal policy setting is lower spending in 2008 and 2009 thus providing more room for private economic activity to forestall inflation pressures.

Spending cuts to target

Achieving $15 to 20 billion in spending reductions requires more political courage than hard work. Most of the adjustment burden is achieved by reversing the worst policy decisions of the previous government. For example, the budget should restore the eligibility requirements for the age pension. This is the single largest spending program of the Commonwealth, with recent real growth in advance of 5 per cent and a steadily ageing population. Then there is the need to cap or means test payments such at the Carers Allowance, telephone, utility and seniors' concession allowances, and to introduce adequate means testing for programs without means testing, or with low level tests, such as Family Tax Benefit B, the Baby Bonus and the Commonwealth Seniors Health Card. And there is the need to restructure politically motivated programmes like Natural Heritage Trust, Exceptional Circumstances Assistance and Regional Partnerships that previously had a blank cheque to spend whatever they liked.

Large savings can also be achieved by scrapping all current indexation arrangements along with the efficiency dividend and replacing these with CPI indexation and directly compensating individuals with less means. Large savings can also be achieved through the widespread adoption of competitive tendering processes, and by incorporating economic efficiency principles into contract design especially for the purchase of large capital items and defence weapons platforms. Large savings can also be achieved through the recentralisation of some departmental expenses functions related to office space, accounting, IT, legal services and human resource management.

The best approach to spending reduction is to spread the pain of adjustment as thinly as possible and to impose the largest share of adjustment burden on those most likely to benefit from resultant resumption of strong growth and lower interest rates. The price of not doing anything - can anyone still remember 1983 and 1991?

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