

# **Expenditure Review Committee 2008: A Framework for Decision Making**

## **Background Briefing 2008/01**

**Date:** Thursday, 13 March 2008



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*In recent times fiscal policy has contributed to creating bottlenecks in the economy by crowding out resource flows to the most productive sectors of the economy. Irresponsible budget policy and public administration has contributed to higher prices and higher interest rates. A discretionary tightening is now long overdue to assist in dampening cost pressures along with a pursuit of fundamental microeconomic reforms in the protected sectors of the economy. The fiscal tightening should be of the order of **2 per cent** of GDP in **2008-09**. This task requires **immediate, decisive** action on the part of government and the full **support** of the **bureaucracy**. Any delay will be measured in terms of higher prices and interest rates and lower growth over the next three years.*

## Introduction

This briefing suggests a framework to assist the new Government's deliberations on the most appropriate settings for budget policy, given the current precarious stance of macroeconomic policy in Australia. For the first time in a decade fiscal policy settings underpinning the 2008-09 Budget could take the lead in of macroeconomic stabilisation, helping to restore strong and steady growth and price stability, whilst supporting national savings and the credibility and sustainability of budget settings.

Fiscal policy has multiple objectives.

- It should assist to **stabilise** the business cycle through counter cyclical tax and spending policies centred on the automatic stabilisers of the budget.
- It should contribute to national **savings** over time and prevent a widening of the current account deficit, and facilitate the elimination of imbalances in the domestic economy, including those created via distorted patterns of saving and investment (Corden 1991).
- It should contribute to **productivity** and long run growth through targeted spending programs which account for the opportunity cost of resources, encourage wealth creation and discourage rent seekers. It should make transparent the cost of all government activities including implicit subsidies and regulation (Starrett 1983).
- It should encourage the **distribution** of adequate means to those most disadvantaged individuals in society over time.
- It should promote **sustainability** of policy by acknowledging all the costs faced by governments and the opportunities afforded us to meet them.



## 1 Recent History of Fiscal Strategy

Running consistent budget surpluses from the mid to late 1990s helped to restore the Commonwealth's balance sheet which had been jeopardised by stubborn and persistent budget deficits even during the recovery of the economy in the mid 1990s. This helped to reduce price expectations, along with the Reserve Bank's inflation targeting mandate. This ushered in an era of low interest rates in Australia which encouraged private sector investment and job creation. But it also had some unfortunate unintended consequences.

By the early to middle 2000s, low interest rates and short sighted budgetary policies had encouraged a debt financed housing boom which is still unwinding today. One Treasury official put it very succinctly:

“Over the last decade, Australia has experienced a housing boom of unprecedented proportions. Both construction activity and house prices have increased dramatically, driven by low interest rates, greater consumer access to housing finance, an increase in net immigration, and continued increases in household income. House prices have also been affected by supply side constraints, particularly on land release (Parkinson 2004)”.

By the middle of the decade the housing boom had absorbed more than half of all new investment in Australia in the first half of the 2000s and added substantially to the CAD and national debt. It was not a clear win for policy as the Deputy Governor of the Reserve Bank remarked at the time:

“This was not obviously related to population growth, which was not unusually high in the recent period. The number of new dwellings constructed was not unusual compared with previous booms. What is new is that the quality and size of dwellings, both new dwellings and those being renovated, are higher than in the past. That is to say, the community has much higher standards for accommodation than was formerly the case, and is investing additional resources accordingly. Was this a good investment? For that part of the investment undertaken in expectation of commercial returns, some reservations must be recorded (Stevens 2004)”.



## 1.1 The Housing boom and inadequate public infrastructure

Much of the investment in housing was debt financed chasing speculative profits rather than patient returns. So the quality of capital expenditure was often poor, encouraged in part by short sighted Commonwealth tax and spending programs which crowded out investment in more conservative, lower yielding, options such as public infrastructure assets or rental accommodation construction in favour of short term capital gains and negative gearing on existing residential properties. This was becoming increasingly obvious by mid to late 2004 when both commentators and the Reserve Bank were noting the inadequacy of public infrastructure in Australia. A case in point was the *Dalrymple Bay Coal Terminal* which was the most transparent example of an infrastructure bottleneck inhibiting the growth of Australian exports.<sup>1</sup> While much of the commentary on public infrastructure issues focused on the need for new public spending to eliminate perceived 'inadequacy' of the existing capital stock, part of the explanation why spending had not yet occurred was due to regulatory and competition issues.<sup>2</sup> A significant impediment to the further development of critical infrastructure in Australia appears to have been the way the current economic regulatory framework is structured and administered, in addition to the fiscal policies of Commonwealth and State governments.

The first evidence of supply side bottlenecks in the Australian economy generated by the China boom also coincided with a rapid upswing in the growth of commodities prices from March 2004. This upswing would continue for consecutive quarters until June 2007, when prices reached a 50 year peak, signalling a significant risk for policy management based on the previous experience post WW2.

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<sup>1</sup> Coal producers still face a congested coal supply chain and ship loading facilities after four years. However, at its peak the queue was 50 ships waiting to be loaded at the Terminal on 30 March 2005.

<sup>2</sup> The States own, operate and oversight (regulate) most of major service delivery infrastructure in Australia like ports, railways, major roads, hospitals, and schools. Along with the Commonwealth they were unable to overcome regulatory barriers to new investment and encourage greater private sector participation.



## 1.2 The Commodity boom and inadequate public saving

The first commentator to see the implications and risks for fiscal policy was Professor Ross Garnaut of the Australian National University who sent a very clear signal to policy makers in December 2004:

“It would help if fiscal policy were now tightened considerably. It would have been better done much earlier, but now is better than later. This would take pressure from domestic demand without raising the exchange rate - as tightening monetary policy would do. But if fiscal adjustment were small or long delayed, and domestic demand growth and non-tradeables inflation continued near recent levels, for all its risks to a debt-ridden household economy, monetary tightening would still be necessary to contain vulnerability to extreme international market responses.

It would have helped if the price index that is the object of the inflation targets had been an index of non-tradeables prices, excluding the deflationary effects of exchange rate appreciation in recent years, and the inflationary effects of any large depreciation in the period ahead (Garnaut 2004).”<sup>3</sup>

Unfortunately, the three Commonwealth budgets from 2004-05 did exactly the opposite to what was required of responsible fiscal management. Table 1 shows the impact of parameter and policy variations on the budget bottom-line for each budget since 1996-97. It reveals the extent of the poor spending discipline that will be a legacy of the previous Government as well as the extent to which the budget bottom-line was assisted by favourable policy and other variations that were neither ‘banked’ by government, nor handed back to taxpayers.

While the previous Government made modest spending cuts over its first two budgets this situation had reversed itself in cumulative terms by 2000-2001 and was exacerbated soon after by the slowdown in activity associated with the introduction of the GST. While some discretionary easing was justified in that year, this was clearly not the case in the budgets that followed. Since the 2001-2002 Budget there has been a discretionary

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<sup>3</sup> I also acknowledge Chris Richardson of Access Economics who has been one of strongest and most articulate advocates for national savings over the past four years.


**Table 1 Impact of Budget Policy Spending From 1996-97**

	1996-97*	1997-98*	1998-99*	1999-00	2000-01	2001-02
	\$b	\$b	\$b	\$b	\$b	\$b
<b>Budget Balance</b>	<b>-4.2</b>	<b>-2.0</b>	<b>3.8</b>	<b>11.9</b>	<b>5.6</b>	<b>-3.4</b>
Impact of revenue policy decisions	1.0	1.9	1.7	1.1	1.8	-1.2
Impact of spending policy decisions	2.0	5.0	2.9	-5.1	-10.6	-10.6
<b>Effect of Parameter Variations</b>	<b>-2.0</b>	<b>-0.8</b>	<b>-1.7</b>	<b>9.1</b>	<b>5.8</b>	<b>-0.5</b>
<b>Budget Balance with 'no change' to discretionary spending</b>	<b>-6.2</b>	<b>-7.0</b>	<b>0.9</b>	<b>17.0</b>	<b>16.2</b>	<b>7.2</b>
Total cumulative impact of spending policy decisions since the 1996 Election	<b>2.0</b>	<b>7.0</b>	<b>9.9</b>	<b>4.8</b>	<b>-5.8</b>	<b>-16.4</b>
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	\$b	\$b	\$b	\$b	\$b	\$b
<b>Budget Balance</b>	<b>4.7</b>	<b>4.8</b>	<b>10.8</b>	<b>14.8</b>	<b>15.4</b>	<b>14.8(e)</b>
Impact of revenue policy decisions	0.5	-4.2	-3.9	-13.8	-19.4	-26.1
Impact of spending policy decisions	-10.4	-15.6	-13.4	-17.6	-27.5	-26.3
<b>Effect of parameter variations</b>	<b>-0.6</b>	<b>9.5</b>	<b>21.5</b>	<b>37.7</b>	<b>56.5</b>	<b>61.4</b>
<b>Budget Balance with 'no change' to discretionary spending</b>	<b>15.1</b>	<b>20.4</b>	<b>24.3</b>	<b>32.4</b>	<b>42.9</b>	<b>41.1</b>
Total cumulative impact of spending decisions since the 1996 Election	-26.8	-42.4	-55.8	-77.4	-104.9	<b>-131.0</b>

**Source: ABS, Budget Papers & Macroeconomics.com.au estimates.**

A positive number for revenue or expenses indicates an improvement in the budget balance. The figures in the table are subject to rounding. \*Prior to 1999-2000 figures are based on the underlying cash balance. There are some major comparability issues around the shift to accrual accounting. For example, the above table does not include the recorded removal of revenues and expenses from the Commonwealth General Government in the 1999-2000 Budget for the 2000-01 and 2001-02 years.

Reconciliation between years to account for the cumulative impact of decisions and parameters is limited by detail provided in various budget papers so that a dollar for dollar reconciliation is not possible. For example, variations occurring in between the last Budget estimate and Final Budget Outcome have not been reported since 1996-97.





loosening of spending currently worth around **\$26 billion** annually. Indeed most of the damage has occurred from the 2004-05 Budget onwards, when it was clear to all and sundry that a terms of trade shock was underway. From this Budget onwards government has spent an additional \$86 billion over three years in new policy, including the current year (2007-08), but excluding the entire forward estimates period.<sup>4</sup> I do not include contribution of these years to allow time for the new Government to correct the situation. However, the calculation including the Budget and out years has been undertaken by Saul Eslake from the ANZ:

“Shortly before the 2007 election I estimated that, since the 2003-04 Budget, so-called ‘parameter variations’ had added some \$457 billion to the resources available to the Government over the nine years to 2010-11; and that, of this amount, \$435 billion had been or would be spent or given away in tax cuts, and only \$22 billion ‘saved’ in the form of Budget surpluses. And of this \$435 billion, at least \$270 billion had taken or would take the form of personal income tax cuts (including those the Labor Party has pledged) (Eslake 2008).”

The justification for all the new policy spending from 2004-05 is highly questionable (with the possible exception of much of the security related expenditures for deployments in Iraq and Afghanistan), based on the state of the economic and trade cycle, given that the bulk of new spending has added momentum to an economy lacking idle capacity. The distribution and number of new budget measures by the Commonwealth government, along with some analysis of the growth of the Australian Public Service over the period, is outlined in more detail in a paper by Laurie & McDonald (2008).

Blind Freddy could have told you by mid 2006 that **INFLATION** was the issue of the day but unfortunately the penny had not yet dropped. One exception occurred on the Sunday program on 6 August 2006 when Opposition Leader Kim Beazley told Laurie Oakes that Australia needed a **mini budget**:

“I think the point about this is that what the Reserve Bank has identified as capacity constraints are creating the inflationary pressures. The poor performance of our infrastructure is creating inflationary pressures. The absence

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<sup>4</sup> This also ignores the impact of tax cuts and the growth in tax expenditures in those years which contributed about the same again to growth.



of the required number of skilled tradesmen is creating inflationary pressures. The threat to our productivity that emerges from all this is creating inflationary pressures. We cannot afford to keep ignoring this, and fail to address it and that is the point of a mini budget. If you have a mini budget based on those considerations, then I think you will have the respect of the Reserve Bank and they will take that into account when they subsequently deliver — deliberate on further interest rate rises or not, as the case may be. The point is you cannot afford Howard's complacency. This is poor economic management as well as breach of trust.”

**Table 2 Structural Budget Balance From 1996-97**

	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02
	\$b	\$b	\$b	\$b	\$b	\$b
<b>Budget Balance</b>	-4.2	-2.0	3.8	11.9	5.6	-3.4
<i>Impact of the Economic Cycle</i>	1.7	2.3	-5.0	-10.5	-3.2	7.0
<i>Impact of the Commodity Cycle</i>	-0.4	-0.5	-0.0	-0.9	-1.1	-1.4
<b>Structural Balance</b>	<b>-5.6</b>	<b>-3.8</b>	<b>-1.7</b>	<b>0.5</b>	<b>1.3</b>	<b>2.2</b>
<i>(Per cent of GDP)</i>	-1.1	-0.7	-0.3	0.0	0.2	0.3
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
	\$b	\$b	\$b	\$b	\$b	\$b
<b>Budget Balance</b>	4.7	4.8	10.8	14.8	15.4	14.8(e)
<i>Impact of the Economic Cycle</i>	-1.2	-2.5	-4.0	-8.2	-12.6	-12.3
<i>Impact of the Commodity Cycle</i>	-1.5	-3.0	-8.7	-12.0	-17.0	-16.4
<b>Structural Balance</b>	<b>2.0</b>	<b>-0.7</b>	<b>-2.7</b>	<b>-5.4</b>	<b>-14.2</b>	<b>-13.8</b>
<i>(Per cent of GDP)</i>	0.0	0.0	0.0	-0.5	-1.4	-1.2

Source: ABS, Budget Papers & Macroeconomics.com.au estimates. Subject to rounding.



One of the most disappointing aspects of the spending outcomes since 1999-2000 (especially over the last three Budget outcomes) has been that the frittering away of hard won gains from economic reforms and transitory gains from the commodity cycle. Table 2 outlines estimates of the structural balance in Australia over the period 1996-97 to the current year 2007-08 based on the *Macroeconomics.com.au* Structural Budget Model of the Commonwealth Budget. It estimates that without the assistance of the commodity cycle and strong economy the budget would now be around \$14 billion dollars in deficit in 2007-08, which in GDP terms is very similar to the size of the structural deficit that existed in 1996-97.

The analysis presented in Tables 1 & 2 implies that the immediate and appropriate target for fiscal strategy should be a discretionary tightening of around **2 per cent of GDP** leaving a buffer of around **\$5 to \$10 billion** in store to safeguard against the need for a easing of discretionary policy if the economy slows. In addition, this analysis does not account for the structural dis-saving of State governments that have failed to 'bank' their own stamp duty and land sales windfalls and have contributed to the growth in public spending. This would argue for a Commonwealth savings target closer to **3 per cent of GDP**. It is my belief that this savings target is larger than that currently under consideration by the new Government.



## 2 Outcome of Fiscal Easing

My hypothesis is that profligate fiscal policy has led to higher prices in an era of full employment which inevitably resulted in higher interest rates. Before the Reserve Bank began the current tightening round, interest rates were at a 30 year low of 4.25 per cent in April 2002. Since that point the structural budget position has deteriorated by around 1½ per cent of GDP on the back of new policy decision worth around \$26 billion each year. Over that period interest rates have risen 12 times by a total of 300 bps. Most of the tightening (200bps) has occurred after the 2004-05 Budget was brought down and I argue below that it is due in part to poor budget decision making and public administration by both Commonwealth and state governments awash with windfall receipts from the housing and commodity booms.

### 2.1 Fiscal policy & higher interest rates via bottlenecks in supply

Movements in short term interest rates are driven by monetary policy and the outlook for inflation which is driven by expectations. The main link between inflationary pressures and fiscal policy is through the level of activity. If policy settings introduce a significant stimulus at a time of full capacity then it is possible that fiscal policy can contribute to higher interest rates.<sup>5</sup> By targeting low positive inflation, monetary policy is implicitly targeting the 'output gap' between potential and actual output. When that output gap is close to zero, any policy action which adds further momentum into demand feeds directly into higher prices.

A rule of thumb for measuring the impact of this stimulus on prices for a fully employed economy is **proportionality**, i.e. any further structural deterioration in the budget leads to a matching percentage point change in consumer prices in the economy. Therefore **one way that governments** can ease cost of living pressures on Australian families is **identifying cuts where demand is contributing to existing bottlenecks** in terms of shortages of skilled labour and infrastructure and by over time building the stock of human capital and public infrastructure.

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<sup>5</sup> Rising interest rates have occurred in part as a result of a malfunctioning public sector through its direct contribution to demand for goods and services produced by the nation as a whole and indirectly by starving the supply of skills and infrastructure in specific sectors through poor quality spending decisions.



## 2.2 Fiscal policy & higher interest rates via risk premia

Movements in long-term interest rates are driven by a combination of factors such as the condition of the public balance sheet public (as well as inflationary expectations). As the credibility of fiscal policy declines, investors may require a premium as compensation for holding government debt in their portfolios.

Research previously undertaken by the author suggests that a **discretionary easing** of the structural budget balance is seen by financial markets as equivalent to a deterioration in the balance sheet of government, using the stock of net debt as a proxy (Comley *et al* 2002).<sup>6</sup> This research suggests that the structural deterioration in the budget bottom-line of between 1½ to 2 per cent of GDP would add around **50-75 basis points to yields on long dated securities** over the short term and around 50 basis points to yields after five quarters. It is also suggests that these long term funding costs feed back into shorter term interest rates as inflation expectations build. If this feedback mechanism is correct, it would imply that around one-quarter of the total increase in short-term official interest rates since the 2001-02 Budget has occurred through the indirect channel of risk premia related inflation expectations. This suggests that the **most effective way for government to relieve cost of living pressures on Australian families** would be to **reverse the deterioration in the structural budget** by finding savings of up to **2 per cent of GDP, immediately**.

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<sup>6</sup> The reduction in risk premia is very much a judgment by the markets on the Government's fiscal performance. I argue that the market considers risk premia to be a function of the stock of Commonwealth net assets. However, risk premia may also stem from factors other than the markets perception of the Commonwealth's financial strength. Alternatively some would argue that imperfect markets may view risk premia only as a function of Commonwealth general government net debt. In this case, further risk premia gains will likely be very small due to Australia's low levels of net debt. Furthermore, the relationship between risk premia and net debt may not be one for one. For instance, risk premia may be very small for 'prudent' levels of debt but grow at an accelerating rate when debt gets above some arbitrary level like the OECD average. Either way, any further elimination of net debt may have a minuscule affect on the size of the risk premia.



### 2.3 Fiscal policy & higher interest rates via administered prices

Poor public administration has also contributed much to cost pressures in recent years leading to higher interest rates. Low quality spending choices, coupled with ineffective processes to review the spending base, have inhibited performance management and supported waste and anti-competitive management and labour practices.

Evidence for this argument can be seen in the growth in **administered prices**, namely price changes in consumables determined in large part by government. A number of items including alcohol & tobacco, utilities, property rates & charges, hospital & medical services, pharmaceuticals, urban transport fares, motoring charges, post, education and child care have so-called administered prices which are set by government, rather than market forces. Administered items represent close to one quarter of the total Consumer Price Index by value. The annual rate of increase in administered prices has been around 4 ¾ per cent since 2001-02 and has consistently outpaced the growth of those consumer prices determined by market forces at 1¾ per cent, per annum, excluding volatile items, over the same period.

The growth in administered prices provides a frequent indicator of the success or failure of competition policy in various protected sectors of the Australian economy because it should not be possible for prices to grow in advance of CPI over the longer term. Therefore another way that government can ease cost of living pressures on Australian families over the medium term is to **undertake microeconomic reforms** focusing on raising competition **throughout the protected sectors** of the Australian economy.



### 3 Assessment of Fiscal Strategy

When measured against the five criteria identified earlier to assess fiscal policy, the recent track record of fiscal strategy has been a failure.

#### 3.1 Criteria for assessing fiscal strategy

The **stabilisation role** for fiscal policy has failed since the modest slowdown in 2000-2001. Theory and evidence suggests that profligate pro-cyclical fiscal policy has contributed to tighter monetary policy than would have otherwise been necessary. There is also a risk that the future tightening of policy will contribute to an economic slowdown some time in late 2009 or 2010 due to the policy tightening occurring too late in the business cycle.

The precautionary **saving role** for fiscal policy has failed in part as seen by the widening of the structural current account deficit which has reached around 7 per cent of GDP in the December Quarter of 2007 fuelled by dis-saving reflected in buoyant consumption expenditure on the part of both the private and public sector. While this is true, it must be acknowledged that over \$80 billion dollars in surpluses were banked by the previous Government which has helped to offset dis-saving in the rest of the Australian economy over much of the past decade and narrow the current account deficit. In addition, the previous Government established savings vehicles such as the *Future Fund*, a valuable institutional development which can be built upon later.

Unfortunately, the previous Government spent more on new policy measure than it banked in surpluses. While it is naïve to expect any government to save all of its windfall gains, surely more should have been squirreled away. It was also necessary to provide an example for State governments that collectively have an even poorer record on national saving. So the pool of national savings is now smaller than it should have been. In addition, very little was done to address the inherent bias against productive investment over the period, but much was done exacerbate the problem.

The enhancing **productivity role** of government spending has also failed inadequate performance of expenditure review processes, including program reviews, and due to flagrant violations of standing budget rules by senior ministers of the previous Government who regularly failed to consult their departments before making decisions. It has always



been true that spending decisions were driven in part by political considerations. But in recent years government perfected the art of targeting record spending announcements to

**Table 3 Real Spending Growth By Function From 1996-97**

	1996-97*	1998-99	Growth	1999-00	2006-07	Growth	Decade
	\$b	\$b	%	\$b	\$b	%	%
Function							
General Public Services	8758.8	8269.2	-2.8	11676.1	14615	3.6	6.1
Defence	12689.3	13257.2	2.2	12949.3	16854	4.3	3.0
Public Order &	1555.7	1264.8	-9.3	1399.3	3318	19.6	10.3
Education	13749.2	13615.7	-0.5	12729.3	16898	4.7	2.1
Health	24358.1	26149.7	3.7	29034.6	39948	5.4	5.8
Social security & welfare	62950.3	63527.8	0.5	70560.0	92075	4.4	4.2
Housing & Community Services	1224.9	1302.4	3.2	2279.4	2909	3.9	12.5
Recreation &	1744.8	1629.6	-3.3	1823.2	2561	5.8	4.3
Fuel & energy	16.8	71.0	N/A	39.6	4635	N/A	N/A
Agriculture	2358.6	2519.9	3.4	2206.4	2831	4.0	1.8
Mining, minerals & manufacturing	2129.4	2087.3	-1.0	1107.5	1920	10.5	-0.9
Transport and communications	1420.8	1354.4	-2.3	2471.0	3296	4.8	N/A
Other economic affairs	4243.9	3740.0	-5.9	3920.9	5165	4.5	2.0
Other purposes	29199.0	33088.5	6.7	31954.3	12339	-8.8	-5.2
<b>Total GFS</b>	<b>166399.6</b>	<b>171877.7</b>	<b>1.6</b>	<b>184150.8</b>	<b>219364</b>	<b>2.7</b>	<b>2.9</b>

**Source: ABS, Final Budget Outcome various & Macroeconomics.com.au estimates.** CPI-NF was used for the price deflator to control for the terms of trade effect. To my knowledge no consistent functional spending series is published in Australia. This situation has not been corrected by the bureaucracy despite repeated requests (Moore 2005, 13) and has assisted in obscuring the extent of the public spending. The best data available is to start with the the functional tables that are published annually with the Budget papers and then to make manual judgement based adjustments to adjust for the impact of GST and the transition from cash to accruals. Underlying cash data rather than GFS expenses were used prior to 1999-2000. If the Department of Finance series is not consistent, the ABS series will be even worse.





marginal electorates via the new's cycle. The brazen way in which ministers announced these commitments in the pursuit of political objectives was truly astonishing. Meanwhile the bureaucracy stood by on the sidelines.

The malfunctioning public sector has affected overall economic performance both through its direct contribution to demand for goods and services and indirectly via its failure to raise the performance of public services in building the skills and quality infrastructure that are in such short supply.

The **distributive role** of fiscal policy to target the most disadvantaged has failed due to a lack of means testing to identify the most disadvantaged individuals in society. Instead the bulk of new social spending was shared with those people who could take care of themselves. Evidence for this is presented in Section 3.3 below.

The **sustainability role** of fiscal policy was compromised through failing to benchmark fiscal policy settings to make the best use of current circumstances and through failing to acknowledge **all** of the policy challenges facing the community over the longer term including those related to the environment and infrastructure challenges. However, the *Intergeneration Report* has been a welcome development. It could be more useful too if it followed the Productivity Commission example of including the States and recognised the broader costs associated with participation and productivity enhancing reforms.

### 3.2 Growth areas of budget spending

So where did all the money go? Table 3 shows real spending over the last period since 1996-97 and divides that into two sub periods between 1996-97 & 1998-99 (the period of consolidation) and 1999-2000 & 2006-07 the period of fiscal easing.<sup>7</sup> The bulk of the new dollars have been spent in social security and health, national security and general public

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<sup>7</sup> Another reason for choosing to divide the 10 year period in this way is the structural break presented by the introduction of the accruals budget management system. Returning to the issue of the functional spending series, there is still in existence 30 years of consistent functional spending data for the period prior to the introduction of accruals, classified by accounting line, along with the corporate knowledge to marry this data with the new gross



services. These spending areas represent the obvious candidates for significant reductions. Breaking these functions down into historical program and agency spending trends as well as agency staffing levels, will no doubt make for interesting reading. Given that there was no clear justification for real spending increases in any area (save national security after September 11), establishing a baseline for discretionary savings should be straightforward and should certainly include savings from all areas that have consistently averaged growth in excess of 3 per cent of GDP (growth not supported by a growing economy).

### 3.3 Worst spending policy decisions of the last decade

So where did the money go? Perhaps a good place to start would be the major policy announcements of the previous Government from 1999-2000.

Perhaps the most short sighted decision of the previous government was to gradually reduce eligibility requirements for the Age Pension, the single largest spending program (\$22 billion) and with an ageing population which should drive spending growth for years to come. Then a number of non means tested programs were introduced such as Carers Payment, Family Tax Benefit B and the Baby Bonus where there are no eligibility criteria whatsoever.

There are programmes like Natural Resource Management, Exceptional Circumstances Assistance and Regional Partnerships with a blank cheque to spend whatever they can that generally fail to get the enough money out the door to meet their budget estimates. Next was the resort to one-off payments before the 30 June over the last four years to reduce the estimated budget surplus in the Budget year. The total of payments averaged \$3.2 billion in each year and included some very *special* causes.<sup>8</sup>

There are programs like the Medicare Safety Net which specifically undermine the goals of first or second best health care policy and were pursued for more ideological reasons and have not improved the quality of outcomes for patients. The list goes on...and on.

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expenses series. A consistent time series produced at a fine level of detail would assist budget and program analysis and planning and would facilitate performance assessment. It would also allow for the back casting of series following any future changes to budget accounting rules.

<sup>8</sup> Discretionary payments to important cultural institutions such as a circus school come to mind.



## 4 Framework for Achieving Budget Cuts

The new Government has been slow off the blocks on macroeconomic management. Their lower energy levels in December 2007 were understandable after a long campaign. Less understandable is why the new Government were not presented with comprehensive savings options to restore the credibility of fiscal policy on the Sunday morning after the election. Instead it appears that PM&C, Treasury and Finance, advice was something like achieve “small and straightforward savings in the May Budget and defer significant reductions pending further analysis which may be completed in the lead up to SMR in November”.

### 4.1 Suggested approach

Significant savings are easily achieved where the facts are put on the table and where political will exists for change. It would have been possible to achieve the necessary reductions in one afternoon if all the relevant parties were brought together in one room with the Department of Finance’s program spending database. The window of opportunity afforded to the new Government during the political honeymoon is soon going to be over. By Budget night 2008, the bureaucracy may have wasted almost 6 months for net savings of less than \$5 billion. Already the RBA has raised official interest rates by 75 basis points since the last election and there is no prospect of reductions in the near term. In addition, it may be that deferring the pain now will contribute to a larger downturn later. The aim of the game of fiscal policy setting in 2008 (and 2009) is to provide more room for the productive sector to do its thing.

### 4.2 Savings targets

The single most effective way the new government can promote the credibility and sustainability of macro policy setting in Australia is to immediately devise a savings package of the order of \$20-30 billion targeting calendar year 2008 (as part of the 2008-09 Budget). The private sector savings offset should counteract the direct impact of the savings package by about one-half (Comley *et al* 2002). However this would still reduce overall spending directly by around \$10-15 billion over the next 18 months with the possibility of second round effects through spending multipliers. If these reductions are coupled with some efficient mechanism to defer the stimulus from the **election tax cuts** than, the package should be perfectly timed at the peak of demand pressures and prevent



further interest rate increases in 2008 and 2009 (Charlton 2008). Ironically this fiscal reduction should help to support activity in Australia while the United States recovers from recession and China slows to single digit growth levels. Slower growth in Australia of around 3¼ per cent in 2008-09, down from the 4¼ per cent forecast at the 2007-08 MYEFO, implies stronger and more stable growth over the outlook period.<sup>9</sup>

Some immediate saving strategies include means testing all welfare payments, not just some, based on wealth, and through tightening the eligibility criteria for certain programs. Large savings can be achieved by scrapping all current indexation arrangements along with the efficiency dividend and replacing these with CPI indexation and directly compensating individual with less means.<sup>10</sup> Large savings can also be achieved through the widespread adoption of competitive tendering processes, and incorporating economic efficiency principles into contract design, especially for the purchase of lumpy capital items and defence weapons platforms. Large savings can also be achieved through the recentralisation of some departmental expenses related to office space, certain legal and accounting services and IT Help Desks.

Some longer term savings strategies should include undertaking a complete audit new government spending decision from 1996-97 to identify waste, duplication and mismanagement in tax and program expenditures. Another straight forward reform would be for government to agree to a list of all its program priorities and to return to the previous practice of reporting budget estimates, appropriations and outcomes against that program list.<sup>11</sup> All agencies should be required to provide program lists and to report against them. It is also necessary to construct consistent historical program spending and functional data for a period greater than just three or seven years as is currently the case. Another way to

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<sup>9</sup> Depending on the composition of the budget savings package, a reduction of around \$30 billion in 2008-09 would reduce output by around 1 percentage point after offsets are taken into account. However, the likelihood is that lower interest rates will further mitigate the decline in output and that by 2009-10 the savings package will contribute to growth in the economy.

<sup>10</sup> This reform would remove the perverse incentives currently associated with the efficiency dividend. This sees agencies bid for new resources to replace losses incurred through the application of the efficiency dividend. This sees smaller agencies with smaller budgets disproportionately targeted relative to large agencies, and agencies (or parts of agencies) that are actually operating efficiently disadvantaged because they incur further costs.

<sup>11</sup> This would aid in performance assessment of various programs and also encourage agencies to publish quantitative and qualitative information about these programs to demonstrate their effectiveness.



achieve savings and efficiency gains would be to hand over responsibility for program and agency health review to the Productivity Commission in conjunction with the ANAO. Further efficiency gains could be identified by having the Productivity Commission review administered prices and by undertaking a stock take of Australia's infrastructure assets each year to identify potential bottlenecks and their root causes as they emerge.

## Conclusion

The paper has two broad messages for policy makers in Australia. Fiscal policy is currently misaligned and contributing to higher interest rates for households and business. That a significant **2 per cent of GDP** discretionary policy easing is justified and should be relatively quick and painless to achieve provided that some tough decisions are made now. However, the window of opportunity will soon close and the risks associated with deferring the hard decisions is great.

*"The Labor Government inherited a public sector that was in poor shape.*

- the tax base was narrow and marginal tax rates excessive. The distorted investment patterns, weakened incentives to work and save, and encouraged tax avoidance and evasion.*
- welfare assistance was not targeted and as a result taxpayers' funds frequently churned through the public sector back into the middle and high income pockets.*
- management systems were inadequate in both the general government and government business enterprise sectors (One Nation 1992, p.12).*



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