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2022-23 Commonwealth Budget Preview:

Is Big Debt Good for Goldilocks or a Roach Motel?

24 March 2021

Overview

This briefing summarises our preliminary views regarding Federal Budget 2022 to be handed down next Tuesday 29 March, at 7.30PM AEST by Treasurer Frydenberg. Our focus the key risks to the medium-term sustainability represented by the prospect of sustained lower growth and higher nominal interest rates. In our view higher rates are the inevitable consequence of unbalanced growth and policy management.

Indeed the key to assessing the long term sustainability of the Federal Budget in 2022 is to compare the projected path of nominal interest rates (r) and nominal GDP (g) – otherwise known as the (r – g) differential. Most experts just 'set and forget' this gap assuming that nominal interest rates remain below growth rates. But defining sustainability is not modelling it. In the real world this is a very risky approach based on an analysis of historical trends. It also runs contrary to a global interest rate environment that appears to have reached a 1970s like inflexion point with surging inflation, especially in the United States.

Our analysis below suggests that a rerun of the (r – g) differential patterns of the 1980s to 2010s would see Australia's fiscal prospects diminished and lessen our optionality to manage future crisis. When running a big debt stock there is a fine line between cosy Goldilock cottage and a Roach Motel, a lesson many Australian government may soon learn.

Table 1: Commonwealth General Government Budget & Net Debt

	Actual	Estimates			Projections	
	2020-21 $b	2021-22 $b	2022-23 $b	2023-24 $b	2024-25 $b	2025-26 $b
Budget Balance	134.3	-84.3	-78.2	-80.9	-53.7	-77.4
Percentage of GDP	-8.3	-4.3	-3.8	-3.7	-2.4	-3.4
Net Debt	**592.2**	**676.5**	**754.8**	**835.6**	**889.4**	**966.8**
Percentage of GDP	28.6	30.5	32.8	35.3	35.9	37.2

Source: Macroeconomics' estimates. Subject to rounding.

Melbourne Office
PO Box 5013, Clayton VIC 3168
enquiries@macroeconomics.com.au

ACN 128 878 535 ABN 901 2887 8535

Australia's total public sector financial liabilities (Commonwealth and State) including unfunded superannuation debt are likely to exceed 75 per cent of GDP by 2025-26. This builds on our internationally high household indebtedness which is in excess of 100 per cent of GDP. Our analysis says that a plausible and sustained increase in the weighted average cost of borrowing faced by the Commonwealth over the next 5 to 6 years will see the debt to GDP ratio almost double by the early 2040s. It seems that policy makers, credit ratings agencies and even some economists are blind to these debt risks and still living in the era of 'lower for longer'.[1]

Australia followed the United States and many other developed economies through the Pandemic by expanding its central government balance sheet via coordinated monetary and fiscal expansion in the face of a zero cash rate floor. This drove up asset prices, accumulated big fiscal debts and will eventually feedback into higher main street prices, as well as predicted by theory.[2] This looks like Modern Monetary Theory by stealth. The argument is that you never have to 'pay back the debt' so obviously money is free money.[3] We suspect that double digit inflation in the United States from the second half of 2022 will test this understanding.

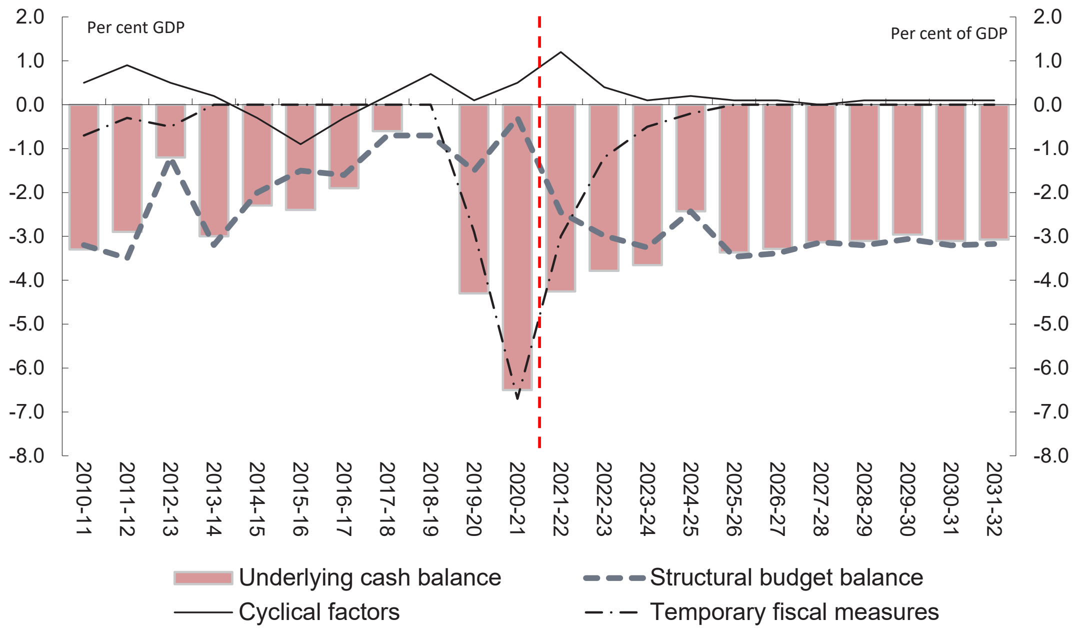
Budget Outlook

The latest Macroeconomics Advisory's budget tracking model places the Commonwealth Budget in a cash deficit by $84 billion (around 4.3 per cent of GDP) in the current year 2021-22, declining a little to $78.2 billion (around 3.8 per cent of GDP) in the budget year 2022-23, with significant deficits remaining over the outlook to 2025-26 (Table 1). These estimates incorporate only minimal allowances for policy changes since MYEFO last December, but no big election spend.

Perhaps unlike some other forecasters, we do not see massive uplift in the Budget bottom-line going forward due to stronger commodity prices and a stronger economy. This will certainly be true if there is a big pre election spend to come.

In our view most of the uplift to nominal GDP from higher commodity prices is already contained in the Economic Outlook. That said, we are still forecasting a strengthening in the bottom-line of about **$43 billion** over four years as the economy continues to rebound from two years of COVID disruption. This is reflected in an improved underlying cash position in 2022-23 by **$21 billion** relative to MYEFO.

Chart 1: Structural budget balance



Source: Budget Papers and Macroeconomics' estimates. Subject to rounding.

[1]P. Commins & J. Tran, Warning that quick fix for budget 'too risky, The Australian, 22 March.
[2]R.E. Lucas., Jr.(2014) Liquidity: meaning, measurement, management, review, Federal Reserve Bank of St. Louis, 96(3).
[3]S. Anthony, (2021). Is quantitative easing good policy? Agenda: A journal of policy analysis and reform. 28(3), November.

Structural Deficits

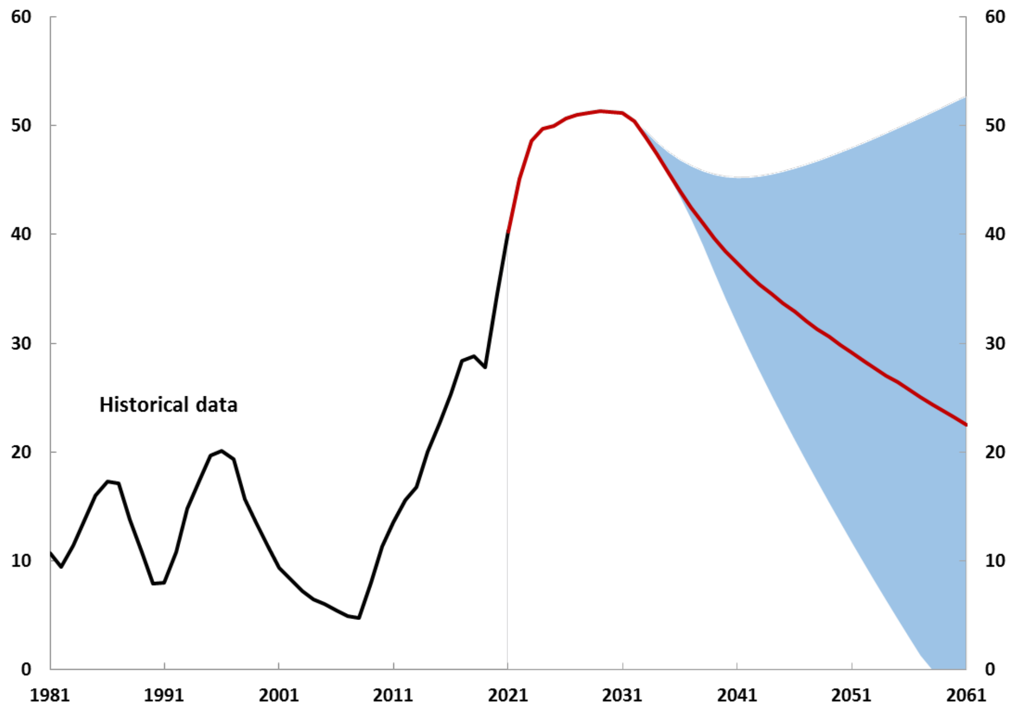
Less positive news is that Macroeconomics' projects a Federal structural budget deficit averaging over 3 per cent of GDP over the next decade indicative of an imbalance between receipts and payments, pointing to a build up in debt over the medium term (Chart 1).

Unfortunately, instead of banking terms of trade windfalls since late 2020, the Federal Treasurer has continued to spend the proceeds of economy recovery. This is after having showered stimulus on many Australian businesses that actually benefitted from the downturn.

Now the Commonwealth budget position is extremely vulnerable to further fiscal slippage, especially given the exaggerated sense of capacity to pump-prime to maintain Goldilocks conditions. Meanwhile Australian governments continue to defer hard decisions about economic reforms which might actually raise trend growth rates over time.

The Parliamentary Budget Office is more upbeat about Australia's capacity to cope with high debt levels even given current global interest settings (Chart 2). They see gross debt falling to 21 per cent of GDP by the early 2060s without further policy tightening. This analysis assumes away risk premia associated with higher debt levels and ignores the productivity lowering impacts of current policy settings.[4] The analysis also assumes debt levels will be sustainable, by projecting nominal growth rates that exceed debt servicing costs over time by fixing the (r – g) differential.

Chart 2: High Gross Debt Leaves No Room For Complacency



Source: see PBO 2022 website.

Persistent differentials

Looking back through time, the differential between the long term interest rate (r) and nominal GDP growth (g) series, or the (r – g) differential, it not necessarily true that nominal growth rates outstrip interest rates over time. This was true in the 1970s, but, on average, not for most of the next three decades. Over the past fifty years the interest rate and growth (r – g) differential has been skewed towards toward positive values.

[4] S. Anthony, (2021).Goldilocks and the three drivers of fiscal sustainability, Tax Policy Journal, The Taxpayers Research Foundation Journal, December.

Table 2: Fifty Years of Historical Averages and Volatility

Variable	Interest rates (r)	Nom. GDP (g)	r – g
1970-79	6.6	13.9	-7.3
1980-89	12.1	11.7	0.4
1990-99	10.2	4.9	5.3
2000-09	7.8	7.0	0.9
2010-19	3.8	4.3	-0.5

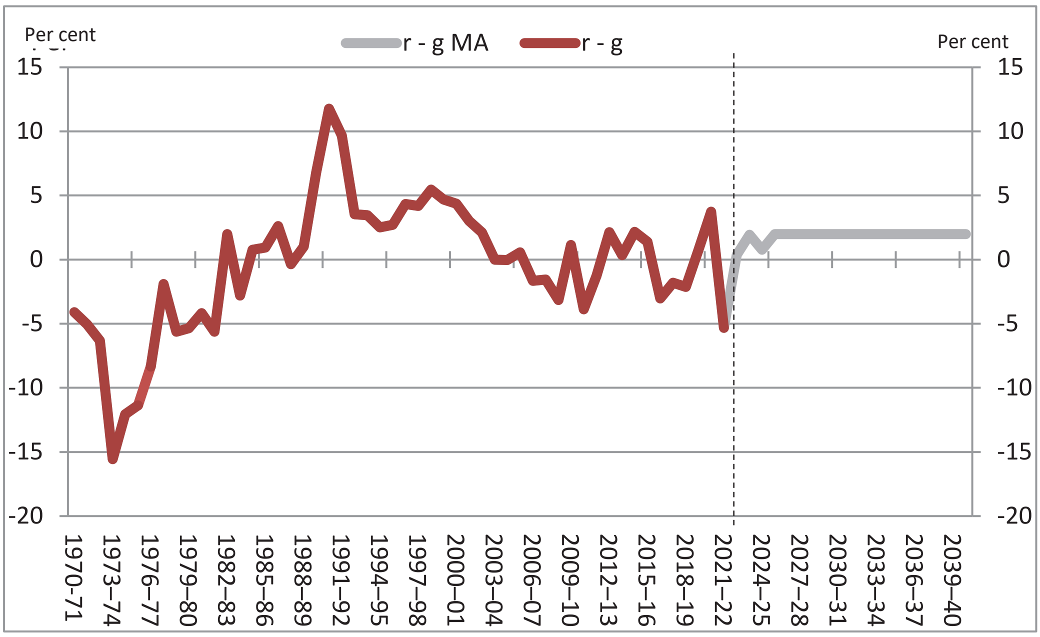
Source: Macroeconomics analysis using PBO Fiscal Sustainability 2021, Table 4-5 & 4-6.

Long Term Projections

Instead of proposing a smooth pathway for the (r – g) differential, we model this differential by assuming the future will look something like the past, played out in reverse. So (r –g) gap gradually increases over the Outlook in our modelling as long bond rates rise, until it reaches around the 2 per cent mark. This is the three decade average level up to the 2010s. We then fix it there for 15 years and set it to zero thereafter (Chart 2). In our view this is a defensible and conservative assumption, especially given the likely progress of long bond rates over the next few decades. Our approach is intended to be a sensible conservative compromise in an uncertain world given we have no theoretical priors about what value the 'gap' should take.

We are also acutely aware that global interest rates appear to have reached an inflexion point – remembering that 10-year CGS was trading at a yield of 75 bps in October 2020 and today that yield is closer to 280bps. The reality is that we have been extremely conservative given what could happen to nominal interest rates as central banks tighten.

Chart 3: Interest rate and growth (r – g) actuals and projections



Source: 2021-22 Budget and PBO analysis.

Budget projections incorporating our long term r- g analysis are set out below in Table 3 and Chart 4. Deficits peak in GDP terms in the 2030s, whereas peak debt is in the 2040s. The Federal government is still left running deficits into the 2050. On this scenario Australia will amass a $4 trillion stock of CGS by mid century.

Table 3: Comparison of payments by key program area 2018-19 and 2031-32

	Estimate		Projections	
	2022-23 $b	2032-33 $b	2042-43 $b	2052-53 $b
Underlying Cash Balance	-78.2	-123.7	-110.7	-93.0
Per cent of GDP	-3.8	-4.0	-2.4	-1.2
Net Debt	**754.8**	**1,703**	**3,130**	**4,077**
Per cent of GDP	30.5	47.4	55.2	45.5

Source: Budget Papers and Macroeconomics' estimates. Subject to rounding.

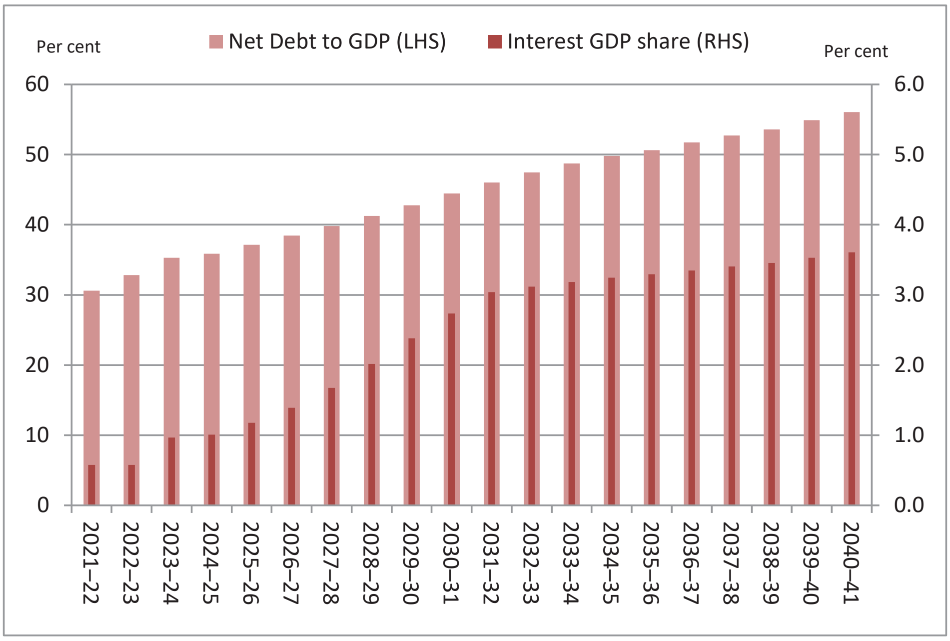
The fiscal deterioration is driven by the combination of higher 'average' debt servicing interest costs and lower nominal growth. These produce lower tax receipts and raise interest costs. The combination compounds through time by reducing the size of the economy each period relative to the size of the debt stock.

- Interest costs rise as a share of GDP rise at times as much as five-fold back to levels last seen in the 1980 (Figure 9).
- Public debt as a share of GDP nearly doubles in net terms and head towards the record levels set at the end of WWII.

In summary, our analysis says that a plausible and sustained secular increase in the weighted average cost of Commonwealth borrowing over the next five to six years could see our debt burden doubling in the early 2040s. This debt build up leaves little scope for funding major structural spending fixes. Nor does it provide any buffer against other national emergencies and global risks.

Our analysis says that we should take remedial action now to guard against the uncertain but possible prospect of a loss of policy flexibility in the future.

Chart 4: Australian Government General Government Net Debt & Interest Cost 2021-22 and 2040-41 % of GDP



Source: Budget Papers and Macroeconomics' estimates. Subject to rounding.

Reform Priorities

What is really generating and expanding the Federal structural deficits are what we call the leaky buckets of the Commonwealth Government. These are a set of inter-related entitlement programs across aged care, social security, disability care, housing and health, which essentially are the proverbial leaky buckets of policy. The holes in each bucket get bigger each year – they are never closed. Together and acting in tandem with State government programs, they generate a downward spiral of welfare reliance rather than self provision.

Then there are the Defense and Energy – Climate spending pressures which are more about the tendency to buy a policy fix before we have an optimising policy program bedded down. Recent examples here are the decade spent dithering over the $200 billion Future Submarine program and the $10 billion Snowy 2.0 white elephant.

Below we make some suggestions about how the spending pressures could be relieved across the Federal government. A feature of our reform ideas is they are revenue positive over a decade and so illicit a favorable structural responses.

Spending control

One innovative way to deal with the leaky buckets of the Budget is to better assist ageing and disabled Australians to achieve right-sized housing, care and income support with far less public subsidy.

Retirement living, aged & disability care

The Royal Commission into Aged Care Quality and Safety highlighted the sector needs up to $12 billion per year just to bring most aged care homes up to basic community standards. Worse, no one really knows just how fast the spending base must grow to accommodate baby boomer demand over the next two decades. But that growth rate will certainly outstrip most other spending programs. Then there is the recent $26 billion blow out in the NDIS program spend. Indeed this program seems to be entirely out of control. Linking eligibility to some substantial private funding base would be a massive structural improvement here.

One obvious funding source is to allow the sale of family homes on a no disadvantage basis, to set aside funding to manage retirement living and /or to provide for a dependent with a significant disability.

Under current means tests, older Australian's are being locked into their primary tax residence, which is often a million dollar plus asset.

Retirees have no financial incentive to sell their home to fund their own retirement living and aged care arrangements, because they are then penalised under the assets test. So many property sales intended to achieve appropriate lifestyle rightsizing are being prevented. This then ties up the asset stock for younger families and helps to keep prices sky high.

Our idea is to allow the full value of the sale proceeds (say up to say $2 million) to be excluded from the means test for the homeowner couple for life. The proceeds from the sale of the home would then be available to fund any right sized accommodation (private dwelling, at a retirement village, or aged care facility). Any remaining proceeds should then be allocated to a special purpose retirement living superannuation account and invested in 30:70 mix of income producing equities and bonds. It would probably make sense to allow those funds to be controlled by a single public entity such as Commonwealth Super or the Future Fund (see below).

Such a proposal would be both innovative and incredibly popular. It would allow consumers trying to do the right thing and provide for themselves to avoid any manner of shonks and spivs promoting reverse mortgages that usually have high transaction costs.

Reliable and adequate incomes in retirement

In 2021-22 the Australian Government will spend up to $40 billion subsidising superannuation saving, whilst never lowering Age Pension eligibility and costs. Nor does it ensure that current and future retirees can purchase a cost effective annuity that can offer them an adequate and reliable income stream for life.

The easiest and quickest way to fix these issues is to establish a single national public default scheme – a future fund of retirement income – that could use its balance sheet to efficiently convert lump sums to annuities, avoiding duplication, and permitting the investing of retirement dollars in ways that better match overall system asset and liability structures and so raising overall risk adjusted returns.

The specialist retirement fund would effectively act as an agent of Government selling annuities to prospective retirees. i.e. selling a top up to the age pension. An upper limit ceiling could be place on the size of the annuity to limit the public subsidy associated with the scheme.

We argue that a single national default scheme for retirement phase could help to improve the efficient transfer of member dollars through default superannuation from accumulation phase into a more valuable income stream for retirees. Right now there is not a clear-cut and cost-effective longevity product for retirees to purchase.

Decision making for retirees on appropriate longevity income products is more a lottery game than a predictable and efficient value transfer. This reform would hopefully reduce reliance on the full and partial pension through time by raising confidence in all phases of the default superannuation system.

Privately, fund chief investment officers will concede a single fund structure is inevitable because it is the structure needed to take personal investment risk out of retirement. The case for the single fund structure will become more obvious during the next sustained bear market.

Tax reform

The focus hear should be on economic rents and base broadening, replacing inefficient imposts like company taxes and stamp duties with more efficient ones like the corporate cash flow tax and land taxes.

For those who are wondering a cash flow tax allows for the immediate write-off of capital expenditure by business. It forces big foreign tech companies to pay their fair share of tax. It leaves most enterprises non-taxable or at least in a better taxable position relative to the standard income tax. It would also be a huge spur to greenfield investment to help build the industries of the future.

Abolishing stamp duties removes another affordability anchor that pulls against Australian families choosing a home that better suits their current and future circumstances.

Fixing energy security

Those who argue that solar and wind should quickly replace coal and gas fired generation by 2030 to meet a zero emissions objective do not seem to understand the full price tag. At Macroeconomics Advisory, we have estimated that the cost of replacing existing thermal power with solar and wind and back up will be in excess of $150 billion and this cost will likely be borne by the Commonwealth and State governments.

Why is it so expensive?

The first is that the material requirements for intermittent energy sources like solar and wind are often misunderstood. If emissions reductions targets are to be met, electricity generation will have to be extended beyond its current uses to cover the majority of energy required in transport and industry. According to the recent AEMO 2022 Draft Report the most likely scenario will require increasing utility scale solar and wind about nine times to get about 150 GW of installed commercial capacity. To build the wind alone would require about 40 million tons of steel, or about nine times our annual production.

The second is that Australia has plans to make our transition with solar and wind as the primary energy sources, together with a significant amount of confidence in the successful development of emerging technologies.

To make things worse, this assumes that the replacement makes sense.

Unlike California and Germany, for example, the execution of Australia's plans do not have the benefit of critical support from an alternative nearby large scale grid. In this sense Australia is unique amongst large industrial economies. The magnitude and extent of the energy required creates extraordinary economy wide vulnerabilities.

The question is, is this a bet we can afford to make?

Many engineers and economists who understand the bet - warn that the proper focus should be achieving low emissions reliable energy. It should not be maximising cheap or zero cost intermittent generation. These two things are not the same and can never be the same.

If you want to live in a cheap intermittent generation world, move to Lagos. Otherwise start investing in technologies that might assist the transition to net zero. Energy = wealth and wealth = energy, without cheap power we revert to a pre-modern economies. If Australia continues to follow a strategy of relying on solar and wind, it needs to pay serious attention to the problem of back up and storage rather than just nominate possible options to be ready somewhere over the rainbow.

One promising existing technology is thermal storage. It is a scalable and compact way of storing energy in a way that provides relatively cheap long duration back up for intermittent systems. These can also run existing coal fired turbines and so retains the value of existing infrastructure and transmission facilities. It provides for lower emissions and the same flexibility, security and stabilisation services currently enabled by thermal generation facilities. It also provides a hedge against the partial failure of the solar and wind program. Even at the low level of about 20 per cent electricity from intermittent sources the Energy Security Board (ESB) has warned of risks to security and stability.

Combining thermal and intermittent co generation creates a more robust system then is usually discussed at a policy level. A combined system retains a stable and dispatchable power supply that isn't subject to simultaneous failure across the grid.

Federal and State governments should consider thermal storage options along with the more favoured solar, wind, hydrogen which are currently and likely to continue to be heavily subsidised both in Australia and overseas compared to an option that appears to requires no assistance whatsoever.

Competition policy

While every galah in the pet shop likes to talk big on the productivity agenda, there is no real desire to undertake the hard reforms or club busting that are required to bring it about, such as finally breaking open the monopsonies and monopolies that impede living standards and the path to higher growth in Australia.

Revisiting the unfinished business of microeconomic reform and national competition policy is critical. That means reforming closed shops such as gigantic tech companies that refuse to pay tax in Australia. Then there are the medical professions – especially the specialist guilds – with their interminable waiting lists – surely the most powerful trade unions in the nation.

Also, subjecting the grocery retail industry (the Woolies - Coles juggernaut) and retail banking industry (the four major banks) to competition reforms such as strengthening of the Trade Practices Act via an 'effects test' and preventing these oligopolies from further branching out into new activities, subsidised by their core business, for example, opening up greenfield retail and industrial sites to new market entrants and preventing the warehousing of prime retail sites.

Conclusion

In 2022 Australia faces simultaneous risks in the international economic and security environment and fundamental fissures in the Federal budget. This is certainly not the time to embrace a 'free money' big debt policy which is the Roach Motel that will leave the Australian economy less scope to manage the major challenges ahead.

It is now imperative that we make some good fiscal choices to free more Australians to provide for their personal long term needs. At the same time we need to set all our policy levers on maximising living standards and opportunities for a current and future generations, just as our forbearers did for us.

Both vision and leadership have been lacking as politicians have been too happy to kick the structural reform can down the road. We hope that Treasurer Frydenberg will confound expectations in next Tuesday's Budget by announcing some real reforms that assist in minimising the structural pressures within the Budget.

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