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Grow the pie rather than eat it

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Illustration: Eric Lobbecke Source: The Australian

THERE is one crucial result in the Parliamentary Budget Office's report on Australia's fiscal position: from 2001-02 on, the Howard government ran structural budget surpluses every year averaging 1.4 per cent of GDP; while every year it has been in office, Labor has run structural deficits averaging 2.8 per cent of GDP. And even accepting the fog of unreality that is Labor's latest budget, those structural deficits will persist through to at least 2016-17.

That performance should cement Labor's grip on the drunken sailor award for fiscal recklessness. But Wayne Swan seized on the PBO report as demonstrating that "the structural deficit began in 2001", despite the report's very first graph showing unprecedentedly high structural surpluses in that year and the next. And the Financial Review's Laura Tingle claimed the report "put the blame for much of the budget deterioration on the Coalition in government", though literally all the structural deficits were incurred on Labor's watch.

Those misconceptions may be laughable, but they have been helped by aspects of the PBO's report. To begin with, the PBO never explains why a structural surplus matters, nor how changes in the structural fiscal balance should be interpreted.

After all, democratic governments, unlike medieval monarchs, shouldn't aim to maximise the net value of their assets but to promote national prosperity. And just as large, persistent deficits impose inefficient burdens on future generations, so large, persistent surpluses can be doubly harmful: first, they imply that taxes, which inevitably distort economic behaviour, are higher than necessary; and second, once debt has been paid down, accumulating surpluses transfers ever greater ownership of the nation's assets to the government.

Good fiscal management therefore seeks a surplus over the cycle just sufficient to manage the predictable alternation of lean years with fat and to absorb major shocks, such as the GFC, that occur from time to time. Given those objectives, the target surplus should reflect the size of the initial public debt, the liabilities that might fall on

to the public balance sheet, and the severity of the shocks to which the economy is exposed.

Having inherited debt of \$96 billion, the Howard government pursued a structural surplus that eliminated that debt and financed future liabilities. But that done, it would hardly have been sensible to run large structural surpluses forever, especially as cutting taxes would increase efficiency and expand GDP.

Commentators such as Tingle, who refer to the fall in Howard's structural surplus from its 2002-03 peak to more reasonable levels as a "deterioration", are therefore showcasing their economic illiteracy. Rather, reducing distorting taxes, such as the fuel excise (which cost the community 70c in lost output for every \$1 of revenue raised), was exactly the right thing to do.

And that was even more true as the Howard government, contrary to Labor's favourite myth, was lowering the ratio of government spending to GDP, which fell from 25 per cent in 2001 to 23.1 per cent in 2007, while the ratio of revenues to GDP had risen to 25.7 per cent by 2005-06 - despite reductions in income tax rates and the fuel excise.

But those facts also seem lost on the PBO, which is itself none too clear on the economics of fiscal targets. Little wonder it makes several questionable calls in its analysis. Two stand out.

First, it understates Labor's spending growth by excluding the stimulus package from its outlay calculations, lowering its estimate of Labor's average structural deficit by 1.1 per cent of GDP.

But that misunderstands the purpose of running a structural surplus, which is precisely to finance spending increases in response to large adverse shocks. By excluding the stimulus, the PBO is assessing the adequacy of a rainy day fund ignoring what actually happened when it rained.

Second, the PBO's preferred methodology takes no account of differences in growth potential under John Howard as compared to Kevin Rudd and Julia Gillard. But as the International Monetary Fund always emphasises, the higher an economy's long-run growth rate, relative to the interest cost of its public debt, the more sustainable is its fiscal position.

The Howard government's reforms - particularly to the labour market - allowed the Australian economy to achieve much lower unemployment without unacceptable inflation risks. That enhanced fiscal sustainability as it increased the level and growth of national output, raising the long-term tax take, while reducing interest rates on public borrowing.

The contrast with Labor could not be more stark. The licence given to union thugs; the imposition of inefficient taxes, such as the carbon tax and the MRRT; the squandering of scarce capital on follies such as the NBN; the proliferation of subsidies, regulation and "green tape"; the resulting crippling of the resource boom: all these slash the economy's ability to grow and so finance spending commitments. The result is a deterioration in the structural fiscal position under Labor, which may be 2 per cent of GDP worse than the PBO suggests.

But even more important than any retrospective assessment are the lessons for the future. Central among those is the need to remove the obstacles to growth. Fiscal repair is not simply about belt-tightening: it is every bit as much about structural reform that restores our growth potential. Indeed, Treasury modelling reported in the budget finds that a permanent 0.5 per cent increase in both the participation rate and labour productivity would fully offset the adverse fiscal impacts of a further 4 per cent fall in our terms of trade.

It is that which should shape Tony Abbott's priorities: for it is only a bigger pie that can fund his worthy social goals. And until Labor's growth blockers are well and truly gone, an enduring return to the fiscal strength of the Howard years will remain a dream.
