AUSTRALIA'S FISCAL STRAIGHTJACKET:

Eight myths about tax and public debt which are holding us back

Fred Argy

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AUSTRALIA'S FISCAL STRAIGHTJACKET by Fred Argy

Summary

The Howard Government and Rudd's Labor opposition have both embraced the notion that in general tax rates and public debt levels should not increase. This fiscal strategy is lazy and timid policy, not good governance It is impeding the Government's capacity to meet the nation's infrastructure needs, forcing it to adopt financing options that are economically less efficient and denying Australians a genuine, well informed choice on the appropriate balance between public and private goods. The fiscal straightjacket is based on several myths about the impact of taxation and government borrowing.

MYTH	REALITY
1. Higher taxes are bad for economic growth	The economic impact of taxes depends on the initial tax level, how the revenue is raised, and how productively the money is spent. There is no correlation between the size of government and economic performance.
2. A public debt freeze is the key to sound public finance	Net public debt is not a true measure of the strength of a government's balance sheet - instead the focus should be on net public *worth* - assets minus liabilities.
3. The private sector is always a more efficient owner-manager of infrastructure than government	The benefits of private design, construction, and operation of infrastructure can be captured without private ownership. The private sector often demands excessive premiums to take on political risk - and when privatised services fail, governments must still step in. Insufficient competition can also mean that the costs of monopoly regulation outweigh the benefits of private participation.
4. Shifting from government borrowing to private equity helps ease pressure on inflation and interest rates	When productive resources of the economy are fully stretched, any new large scale debt-financed investment runs the risk of generating inflation but this risk is not reduced by transferring financing responsibilities to the private sector. In either case, inflationary pressures can be avoided by judicious timing of the investment or by discouraging or deferring other types of national spending. Government debt does not affect the international cost of credit.
5. If a particular infrastructure project cannot be sensibly financed by the private sector, revenue can fill the gap	It is unfair to ask today's taxpayers to cover the entire cost of investments that will yield returns far into the future. Current revenue should primarily be used to pay for current expenses.
6. There is no evidence that the fiscal straightjacket has impeded infrastructure investment	Public investment is lower today as a proportion of GDP than it was 15 years ago, and has been dropping faster in Australia than in comparable countries. The greatest decline (in both economic and social infrastructure) has been in forms of investment which do not lend themselves to private equity funding.
7. Running structural fiscal surpluses is good for national productivity	By holding back investment in high-return areas such as education, health, early childhood, training, transport, etc, our obsession with surpluses may actually be holding back Australia's productivity growth.
8. The community prefers lower taxes and does not like the idea of governments borrowing	Opinion polls show a clear preference for increased spending on health and education over tax cuts. The community is only uneasy about government borrowing because they have been told it is financially irresponsible by both major parties - effective leadership could put an end to this misconception.

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AUSTRALIA'S FISCAL STRAIGHTJACKET

Introduction

There is widespread consensus amongst policy makers that while governments need to be responsive to short-term cyclical fluctuations, they should set their budget strategy in a sustainable medium term framework (i.e. over the business cycle). This is agreed to be good for policy predictability, financial market stability and public accountability.

But this leaves an unanswered question: what is the appropriate medium term fiscal stance?

The Howard Government has locked itself into a fiscal straightjacket by promising that over the business cycle, the following two policy settings will hold:

» tax receipts will not rise relative to gross national product; and

» there will be no net government borrowing (no increase in public debt).

This double barrelled fiscal stance effectively sets a ceiling on tax rates and then insists that all government spending, including all capital spending, should be fully paid for out of tax revenue. Kevin Rudd has called it "fiscal orthodoxy" and has enthusiastically committed a future Labor government to it.

For the government's part, Treasurer Peter Costello takes every opportunity to lambast state governments for maintaining excessively high tax levels and for recently reversing their decade-long anti-borrowing stance (even though the states will be borrowing only to pay for new long term infrastructure). Yet the rationale for the Howard Government's structural fiscal stance is questionable. It is based on a series of myths or half-truths. This paper examines eight of these myths.

Myth 1: Higher taxes are bad for economic growth

While tax policy is often portrayed as an inevitable "race to the bottom" between competing nations, few economists accept the generalisation that higher taxes hinder economic growth. The economic impact of higher taxes depends on the initial tax level, how the revenue is raised and how productively the money is spent.[1] Tax increases can have significant incentive costs (though even here there is considerable controversy [2]) – but these costs can be minimized by choosing tax instruments carefully. Indeed, the costs of higher taxes are often outweighed by the economic benefits of the spending programs. That's why it is hard to find a significant statistical correlation between size of government - levels of government spending and taxation - and economic performance.

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Those who support lower government spending argue that 'government failure' is worse than 'market failure', and that there is therefore a need for a 'disciplined and restrained approach' to public spending. On the other hand, those who want governments to spend more on infrastructure, education, health, early childhood intervention and so on, can make excellent social arguments for these policies.

The 'big government' versus 'small government' debate is essentially a difference of opinion based on ideology – not economics. Each proposal requiring higher taxation should be assessed on its economic and social merit without any presumption for or against.

Myth 2: A public debt freeze is the key to sound public finance

This claim simply doesn't make sense. Net public debt - the difference between the government's stock of financial (mainly debt) liabilities and its financial assets - is not an appropriate way to measure the strength of a government's balance sheet.

Instead, the focus should be on net public *worth* - all financial and non-financial assets minus all liabilities. If governments borrow money to invest in productive assets with a comparable life to the debt, this adds to net public debt but does not detract at all from net worth. Depending on the investment, it may even increase net worth in the long term.

Prudentially, the only requirement on governments should be to ensure that over the medium term, they run a net operating surplus (an excess of current revenue over *current* expenses) and borrow only to invest in projects that have met the standard cost-benefit criteria. This should ensure that net government worth is stable or rising and that public debt is kept at a serviceable level over the long term.

Australia's public debt levels are among the very lowest in the developed world...

This is the stance currently adopted by state governments and by most other OECD governments [3]. It is only the Federal Treasurer who is out of line.

Australia's public debt levels are among the very lowest in the developed world (less than one twentieth of the OECD average relative to GDP). All Australian governments have very strong (although lazy) balance sheets[4] and our credit rating agencies are generally relaxed about an increase in government borrowing for investment purposes.[5] This suggests that Australia has more - not less - freedom to borrow than other OECD countries.

Myth 3: The private sector is always a more efficient owner-manager of infrastructure than government

This is another axiom of the current economic debate, but there is scant evidence to support it.

There is little doubt that the private sector is generally better than the public sector in the design, construction and operation of infrastructure. But private ownership is not required to capture these benefits. Governments can and do outsource most operational matters to private operators and consultants, while still retaining ownership of the assets involved.

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The efficiency case for *private ownership* is based on a number of questionable premises.

Firstly, it assumes that the equity risks of the infrastructure project are largely commercial in character. In fact, the equity risks are often more regulatory and political in character. In such cases, the private sector is likely to demand an excessive risk premium, as the users of many of Australia's toll-roads and tunnels have found.

Secondly, the government is not always able to effectively transfer to the private sector the ultimate risk of default. Whatever the formal contracts might say, if a privatized hospital, school, road or railway network fails to perform, voters still hold the government responsible, often leading to costly bailouts of the new private owners.

Thirdly, private ownership is able to deliver benefits to users only if there is sufficient competition both in financial and service markets. The market for infrastructure finance has now matured and is fully competitive; up-front transaction costs such as fees to financial intermediaries are now more reasonable than they were. But it remains hard to avoid quasi-monopoly market power in many infrastructure service markets. In these circumstances, privatisation requires close regulation and monitoring to ensure accountability, transparency and reasonable prices. The cost of enforcing and complying with watchful regulation can remove many of the efficiency advantages of private participation in such cases.

Nor is it certain that private ownership will lead to improved managerial incentives. Government agencies are often derided for their lack of modern management expertise, but in recent years they have developed ways to auction out community service obligations which avoid opportunistic political interference while also giving managers clear goals and well-structured performance incentives. Private ownership comes with its own management problems - the management decisions of listed companies for example are frequently distorted to satisfy the short-term demands of the financial markets.

Finally, an insistence on private equity financing can lead to the misallocation of resources. For example, it tends to create a bias in favour of infrastructure investments with commercial potential and against social infrastructure, an issue addressed later in this paper. In the case of new roads, privatisation can distort patterns of usage, for example by encouraging motorists to take less time-efficient routes.

In view of these limitations, it is not surprising that a recent OECD study of country experiences [6] finds there are only "limited" efficiency gains from reliance on the private sector for the ownership and provision of social protection.

Private equity financing will often be able to save taxpayers money and offer a service which is cheaper and more responsive to consumer preferences. But governments should not start with a presumption that it is always superior to public ownership, which is what the embargo on net public borrowing implies. Each case needs to be assessed on its own merits.

Myth 4: Shifting from government borrowing to private equity helps ease pressure on inflation and interest rates

This view about the impact of government debt on interest rates and inflation is widely held - even by people who should know better [7]. Yet it has little validity.

The pressures on demand, inflation and interest rates are the same whether new infrastructure is financed by public or private debt.

The ultimate constraint on new government investment is the productive capacity of the economy. If the productive resources of the economy are fully stretched at the start, new investment does run the risk of generating inflation and pushing up interest rates. However, transferring ownership responsibilities for new infrastructure to the private sector does not remove this constraint. The pressures on demand, inflation and interest rates are the same whether new infrastructure is financed by public or private debt. In either case, what is needed is good cyclical demand management (such as deferring investment or reducing national spending in other areas).

But are global financial markets more likely to react negatively if a major new program of infrastructure investment is financed by public sector borrowing rather than by private interests? In other words, will markets punish governments with an extra interest rate "loading" for country and sovereign risk?

In the past, credit rating agencies have shown some unease about government debt-financed investment, because of the lack of commercial and market disciplines in decision-making and the danger that it might create useless 'white elephants'. But with Australia's public debt levels now at historically low levels, and provided that new infrastructure decisions are made on the basis of sound cost-benefit evaluations, rating agencies and financial markets can be expected to take a more sensible and relaxed view of both public sector and external deficits.[8]

Myth 5: If a particular infrastructure project cannot sensibly be financed by the private sector, revenue can fill the gap

Relying on current revenue to pay for the full cost of new social investment is not a viable alternative to government borrowing.

Firstly, it is unfair to ask today's Australians to pay upfront for new capital spending that will yield returns over a period of several years or even decades. Revenue should only be used to pay for annual accrual expenses such as interest, depreciation, operational and maintenance costs.

Secondly, the use of tax revenue when the borrowing alternative is preferable has an economic efficiency cost in the short term. It may squeeze out desirable recurrent outlays, and if it leads to higher tax levels it could discourage work at the margin and force people into less preferred choices.[9]

Thirdly, as the capacity of federal governments to fund the up-front capital costs of infrastructure out of current revenue is limited by the self-imposed ceiling on tax levels relative to GDP, reliance on revenue in lieu of borrowing creates a bias against social infrastructure (relative to private commercial investments or self-funding economic infrastructure) in the same way as over-reliance on private financing.

...reliance on revenue in lieu of borrowing creates a bias against social infrastructure...

Myth 6: There is no evidence that the fiscal straightjacket has impeded infrastructure investment

One of the key concerns raised by critics of the present fiscal straightjacket is that it has led to neglect of Australia's public infrastructure – especially social infrastructure.

Evidence for this neglect can be found in three main sources: macro outcomes, micro surveys/studies and public opinion.

First, the macroeconomic data. Public investment is lower today as a proportion of GDP than it was fifteen years ago. In the late 1960s, public investment was equal to one-half of private investment. Today, it is barely one-fifth.

This is a significant decline, but by itself it does not prove fiscal neglect. Other factors, such as an increase in cost-based pricing (which affects demand), may be involved. Or the drop may reflect past over-investment in some areas and a shift from public to private financing.

But the decline in public investment has been more rapid in Australia than in many other comparable countries.[10] And it turns out that the most marked decline has been in areas of social investment which do not lend themselves easily to private equity funding. We will return to this issue in greater depth below.

Second, turning from aggregate statistics to sector-specific surveys and studies, there is plenty of evidence of deficiencies in economic infrastructure in important pockets of the Australian economy - such as power generation capacity, telecommunications, seaports and coal terminals.[11] Perhaps more noticeable to the ordinary voter is the slow run-down in social infrastructure: public schools, hospitals, urban roads and transport, child care, training, lifelong learning institutions, community and preventative health care facilities, rail tracks, energy and water supply, age and disability care institutions, and public housing.[12]

This is important because there are many credible cost-benefit studies showing that social investments yield high marginal social returns (perhaps the best example of which is the large body of research demonstrating the value of investing in early childhood development programs).

Finally, opinion polling shows a widely held and growing disenchantment with the standard of public services, especially in big cities and in regional areas, and a strong willingness to pay more taxes to improve the quality of services.[13]

If we accept that there is a shortfall in public investment, what is to blame?

As governments constrained their investment spending to fit into the fiscal straightjacket, social infrastructure has been the main victim.

We know the private sector has been eager to participate in projects with a reasonable cash flow, albeit with government guarantees or subsidies at times. So the deficiencies in economic infrastructure are more likely to be due to bad planning, poor management, or tax disincentives than lack of finance.

On the other hand, private finance is less suitable for social infrastructure projects because such projects are relatively complex, long lived and capital-intensive, with long pay-back periods. They seldom generate sufficient reliable revenue to make them even approximately self-funding, and due to the need for cross-subsidation of some groups of users on equity grounds, they face special challenges when it comes to charging users for their services.

Therefore, if governments set themselves an arbitrary goal of zero or low net borrowing (as has been the practice for much of the last decade), and if alternative methods of financing social infrastructure are unacceptable or subject to constraints, the effect must be to create an artificial bias against such investments.

As governments have constrained their investment spending over the last decade to fit into the fiscal straightjacket, social infrastructure has been the main victim. This has happened at the same time as a long-term decline in the share of non-cash benefits going to the poor.[14] It is also significant that the decline in public investment has been most marked in 'General Government' fixed capital non-defense spending; in other words, education, health, housing, transport and community amenities. Spending by government trading enterprises – which is mainly on economic infrastructure – has held up better.[15]

True, some of the gaps in social infrastructure supply can be corrected by other means than new investment. For example, in transport the misallocation of public capital is a problem – we spend too much on roads and not enough on public transport. There is also a need for pricing reforms in some areas (congestion taxes in our cities might be a good place to start). However, the most important factor contributing to our infrastructure deficiencies has been the embargo on new government borrowing.

Myth 7: Running structural fiscal surpluses is good for national productivity

The argument that fiscal surpluses boost productivity can be turned on its head. Could it be that our long series of surpluses has actually harmed national productivity?

Could it be that our long series of surpluses has actually harmed national productivity?

As already discussed, the embargo on government borrowing tends to have efficiency costs, ramping up the tax burden in the early years of an investment and encouraging governments to use private financing when it is not the optimal choice.

More fundamentally, the present fiscal stance artificially constrains the ability of governments to choose between social and economic infrastructure and between private goods and collective services, even when the latter offers relatively high marginal social returns. In particular, it creates a bias in the allocation of capital which acts against many types of social investment: public schools, hospitals, urban roads and transport, child care development, training, lifelong learning institutions and community and preventative health care facilities. Capital markets work very imperfectly. They have a tendency to ignore wider economic benefits for 'third parties' not directly involved in market transactions, such as effects on the environment, travel time, accidents, and the productivity of the unpaid household sector. Further, they tend to under-invest in merit goods such as health, education, job search, specific training and certain kinds of infrastructure.

While government failure is also rife, and needs to be taken into account, it is ideological bigotry to assume that governments are always incapable of correcting for market failures. A number of credible studies have found national economic returns (in terms of real incomes per head) of between $2 and $10 per dollar of government outlays on early childhood disadvantage and broader access to health, education, housing, public transport and improved urban freeways.[15]

The gains come in myriad forms: a better educated and skilled workforce; greater geographic and occupational mobility of labour, less waste of potentially successful entrepreneurs, higher employment participation rates, diminished health costs, lower imprisonment rates, less spending on welfare and juvenile delinquency, savings in commuting time, lower accidents and reduced pollution. Our creaking social infrastructure may now be holding back Australia's productivity growth.

International studies show that governments (notably the Nordic democracies, Ireland, the Netherlands and Austria) that choose to give relatively high priority to social investment have been very successful in reconciling high levels of social redistribution with good or even superior economic outcomes.[16]

The perception that governments are trying to achieve genuine equality of opportunity through social investment can reduce the risk of community backlash against further efficiency-driven economic reform.

Myth 8: The community prefers lower taxes and does not like the idea of governments borrowing

When Australians are simply asked if they want lower taxes, the majority unsurprisingly say yes. But when they are asked to express a preference for lower taxes relative to additional spending on such things as health, education and the environment, the responses are much more in favour of spending.[17]

...who doesn't want better roads, world-class public hospitals, good schools and less pollution?

It is true that the electorate is uneasy with large-scale government borrowing. But the most likely reason for this is that voters have been told that it is financially irresponsible by both major parties for so long. Australians would probably respond much more positively if they were told that government borrowing for investment purposes is prudentially sound, that it would improve the quality of public services in concrete ways, and that, if the spending is well timed over the cycle, it would have no adverse effect on interest rates. After all, who doesn't want better roads, world-class public hospitals, good schools and less pollution?

The present fiscal stance poses a basic democratic problem: by setting arbitrary fiscal targets, governments are restricting their own ability to respond to the preferences and expectations of the community. The result is that as a society, we are being prevented from exercising the full range of choices available to us.

CONCLUSIONS

Australia has got itself into a fiscal straightjacket – one which arbitrarily presumes that lower taxes and lower public debt are always good for the economy and in line with community preferences.

This policy stance doesn't score well on grounds of economic efficiency, social well-being or democratic legitimacy. With Australia's public debt and tax levels at very low levels – both historically and compared with the rest of the world - and with our social and environmental infrastructure perceived by most Australians to be in a state of neglect, it would be in the national interest to relax the present fiscal straightjacket.

This policy stance doesn't score well on grounds of economic efficiency, social well-being and democratic legitimacy.

Instead of attacking the states for their current modest borrowing programs, the federal government should be taking the lead on a more coordinated national approach to infrastructure development priorities, as well as allocating a bigger share of its windfall revenue from the commodity price boom to new infrastructure. And, while giving due consideration to private-public partnerships, it should not rule out government net borrowing or tax increases over the economic cycle - subject to some basic checks: proper cost-benefit evaluation processes, sensible timing of spending over the business cycle, reasonable limits on the *rate of increase* in public debt levels, and a commitment to maintain or increase public sector "net worth" in the medium term on an accruals accounting basis.

This alternative fiscal strategy has no chance of acceptance in the present heated election atmosphere. But in the longer term we should seriously consider it.

Endnotes

1 See Argy (2006), pp57-60 and Argy (2007-2), as listed in References.

2 Keating points to literature which finds that "there is not much empirical evidence of taxation affecting the supply of labour or saving", see Keating (2004), p29, in References.

3 The UK, for example, seeks only to keep the operational account in the black and borrows if it needs to invest in excess of its annual savings. The EU countries are bound not to exceed a cash deficit of three per cent of GDP over the cycle.

4 NSW, like most other states, has a high and rising net public worth.

5 See, for example, comment by Standard and Poor that the AAA rating of NSW is not under threat "because of its strong balance sheet" (Alan Wood, *The Australian,* 24 February 2006). Hugh Emy in *Australian Fabian News,* June 2005, observes that "it is clear from comments by Standard and Poor that investment aimed at expanding long-run economic capacity is more likely to support than diminish credit ratings in the long run".

6 "Should we extend the role of private social expenditure?" OECD Social, Employment and Migration Working Paper no. 23, 2005.

7 Mr Costello blasted the states for "running deficits" (borrowing) because it would put upward pressure on interest rates - but in the same interview he said that he had "no problem with bank financed private debt" (Marc Moncrief, *The Age*, 8 June 2006).

8 Two papers by Treasury officers lend strong credence to the view that financial markets are more relaxed about an increase in government and external debt when public debt levels are low. See Gruen and Sayegh (2005) and Comley et al (2001), in References.

9 See Argy (2007), p149, in References.

10 Kamps (2006) shows that the government net capital stock as a percentage of GDP at 1995 prices was 19th lowest out of 22 countries in 2000 compared with a ranking of 11 in 1980. See also Hugh Emy in *Australian Fabian News*, June 2005. If one assumes a stable relationship between the desired stock of capital and level of GDP, then in a period of accelerating economic growth, like the present, the ratio of infrastructure investment to GDP should be rising in Australia. It is only in the most recent year that public investment has taken off, driven by state government infrastructure spending.

11 For example, in transport, much has been said of the problems of the Pacific Highway and the lack of an inland north-south rail freight link or corridor. Also there are concerns about coal supply bottlenecks such as Dalrymple Bay terminal in Queensland (Adele Ferguson, *The Australian* 18 July 2007).

12 See Argy (2006), chapter 4.

13 25 per cent of Australians don't have faith they would receive adequate hospital treatment if they had an accident, according to a recent Roy Morgan Research survey. See also Argy (2006) p47, 55.

14 See ABS' Government Benefits, Taxes and Household Income, Australia, 2003-04 (ABS 6537.0); Victorian Government study Shared Future (2004); and Ann Harding in *The Australian,* 25 February 2002.

15 See ABS' Australian System of National Accounts, 2005-06 (ABS 5204.0).

16 See Argy (2006-2), pp64-65. See also Abelson et al (2003) and Fitzgerald (2003). The Business Council of Australia commissioned a study in 2005 which estimated a $16b permanent increase in GDP from $90b spent on infrastructure – mostly economic rather than social. Research modeling by The Brotherhood of St Laurence indicates that every dollar of investment in community enterprises that tackle local, long term unemployment could yield societal benefits of $14 (Tony Nicholson, Australian Policy Online, 12 September 2007).

17 See Argy (2006-2), pp66-7 and 75ff.

18 See sources in Argy (2006), p58.

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