

Fixing Australia's Budget Deficit – Analysis of Australian Treasurer Scott Morrison's "Bloomberg Address"

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Scott Morrison has correctly diagnosed the problem, but needs to be flexible about solutions

Federal treasurer Scott Morrison's diagnosis of the risks and challenges confronting the Australian economy, as set out in his [Bloomberg Address](#) in Sydney, is hard to fault. Australia has become very dependent on continued strong growth in the Chinese economy for our ongoing prosperity. However, China's ability to sustain continued strong growth over the medium term is imperilled by the increasing volume of (actual and potential) bad debts in both its formal and "shadow" banking systems.

There's also a growing risk of a liquidity crunch, against which China's substantial foreign exchange reserves may not provide adequate insurance.

Australia's terms of trade continue to fall – unwinding much of the massive upswing that occurred during the commodities boom of the preceding decade. We are also seeing very low levels of inflation across the developed world, much of the developing world and more recently here in Australia as well.

The earnings problem

All of this means that we now have what the treasurer calls "an earnings problem".

The growing pressure around the world (and here in Australia) for greater control by national governments over the movement of goods and services, capital and people across national borders – reversing the general trend of the last three decades – does represent a genuine threat to the global and national policy settings which have helped make it possible for Australia to enjoy 25 years of more or less continuous economic growth.

And, partly as a result of the inability of successive Australian governments to fulfil their undertakings to return the budget to surplus, Australia is now less well-placed to use fiscal policy to respond to any economic shocks that may emanate from abroad than we were at the onset of the global financial crisis.

For a different set of reasons, which Glenn Stevens outlined in his [final speech](#) as Reserve Bank governor, we are also less well placed to deploy monetary policy to the same end than we were then.

Thus the treasurer made a solid case for action to ensure the budget is returned to surplus, and the level of public debt reaches a peak and begins to come down.

The taxed and the taxed notes

The treasurer is also right to identify as a problem the fact that, as he put it:

More Australians today are likely to go through their entire lives without ever paying tax than for generations. More Australians are also likely today to be net beneficiaries of the government than contributors.

That's partly a consequence of an ageing population. But it is also the direct result of a whole series of decisions made during the last two terms of the Howard government.

That's when a raft of new status-based (as opposed to needs-based) entitlement programs were introduced, and when a wider range of individuals (including people over the age of 60, small business operators, people with significant superannuation balances, and people earning income in the form of capital gains) were granted preferential income tax treatment compared with wage and salary earners. This continued under the Rudd and Gillard governments.

And while both the previous Labor government and the Abbott and Turnbull governments have sought to unwind some of this largesse – indeed, that's what the superannuation measures in Scott Morrison's first budget were partly about – none of them has been willing fully to acknowledge this reality.

According to forecasts set out in the 2016-17 [federal budget](#), government spending is set to be fully 1.5 percentage points higher as a proportion of GDP in the current financial year than the 24.3% which it was, on average, during the Howard-Costello years.

And the Turnbull government has no plans to return it to that level: the longer-term projections in the 2016-17 budget envisage government spending declining as a share of GDP to 25.2-25.3% of GDP over the next decade.

Rather, the government expects revenue to increase from 23.3% of GDP in the current financial year (a percentage point below the average for the Howard-Costello years) to 25.5% of GDP (half a percentage point above the average for the Howard-Costello years) in a decade's time.

Yet if what the treasurer refers to as Australia's "earnings problem" persists, it will be on the revenue side of the budget that the reasons for the inability to return the budget to surplus will reside, at least in the first instance.

Grasping the nettle

Against that background, it scarcely makes sense that the government's two most significant initiatives – in terms of their long-term impact on the budget – are a big increase in government spending (on defense procurement) and a big reduction in taxes (in the form of phased reduction over ten years in the company tax rate).

Both of these measures make it harder, not easier, to return the budget to the position where the treasurer rightly wants it.

It's fair enough for the government to insist that the Opposition support saving measures it supported during the election campaign. But it hardly seems reasonable for the government to, as the treasurer put it, "expect them to engage on expenditure savings they have habitually blocked" while the government refuses to countenance revenue measures it has previously opposed.

It's encouraging to see the treasurer seeking to lead the sort of hard-nosed conversation that Glenn Stevens called for last month in his valedictory speech as governor of the Reserve Bank.

But a conversation is a two-way exercise. If Morrison is to achieve the goal he seeks, he will need more flexibility on how to get there than was displayed today.