A Surplus? That's The Least Of Our Worries

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Yesterday's economic figures aren't worth taking too seriously - and neither is Labor's surplus. Our weak revenue base, and an incoming Coalition government are the real issues, writes Ian McAuley.

Economic policy in Australia is bound by two obsessions. One is to return the Commonwealth Budget to surplus, and the other is not to raise taxes.

Monday's Mid Year Economic and Fiscal Outlook (MYEFO) was shaped by these obsessions. It is poorly named, because it is more than a mere "outlook". It was accompanied by a number of savings and revenue-raising measures, all designed to meet the objective of a surplus budget in this financial year, 2012-13.

That surplus was to be a wafer-thin $1.5 billion when the Budget was presented in May. It is now as thin as the cucumber slice in an English sandwich, at just $1.1 billion — less than $50 for every Australian.

In a $370 billion budget such a small figure is really about impression management. If receipts were to fall by just 0.3 per cent, the surplus would be wiped out. Economically such an outcome would be neither here nor there, but the squeals from the opposition and its allies on talkback radio would drown out any chance of a sensible policy debate in the pre-election period.

The main problem has been on the revenue side. Between May and now projected taxation receipts have fallen by $3.9 billion, from $343.1 billion to $339.2 billion, but that's hardly a big variation (and is largely compensated by an increase in non-taxation receipts). A company which managed to keep its budgeted revenue within such a tight margin halfway through the year would be seen to be doing very well, but that's not the way politics works. Politics trumps commonsense economics.

Not that the measures announced in the MYEFO are all poor decisions. A sense of budgetary constraint provides a useful cover to take some economically sensible but politically difficult measures. There have already been hollers of protest about the cuts to the baby bonus and the subsidies for private health insurance, but these are in line with the Government's general policy of cutting back on middle-class welfare. Less defensible are some of the program cuts and measures such as visa application charges (it's always easy to tax foreigners). And some initiatives, such as more frequent collection of taxes from large companies, merely shift cash receipts from one year to another — so much for accrual accounting!

Beyond this year the figures are fairly meaningless anyway. Of course we expect the Commonwealth to produce these estimates and projections — the MYEFO is a requirement enshrined in legislation. But there are many political and economic contingencies relating even to the current financial year, and many more in the four years covered by the MYEFO.

The main uncertainty is the US election, which is just two weeks away. While the US does not have the economic clout of a generation ago, it still accounts for more than a fifth of the world economy, and its financial markets have a huge influence on global economic conditions. A Republican victory, if Romney were to implement his economic agenda, could see that country plunged back into recession.

Much of Europe, to put it mildly, is politically and economically unstable: even the IMF is coming to realise that austerity, particularly if it brings out angry crowds on the streets, does not generate a recovery and leaves lasting damage, but for now no realistic alternative policy is emerging. China seems to have had a "soft landing", but its future path of growth will undoubtedly be more towards developing its service industries rather than its manufacturing and construction industries, which to date have fuelled demand for our iron ore and coking coal.

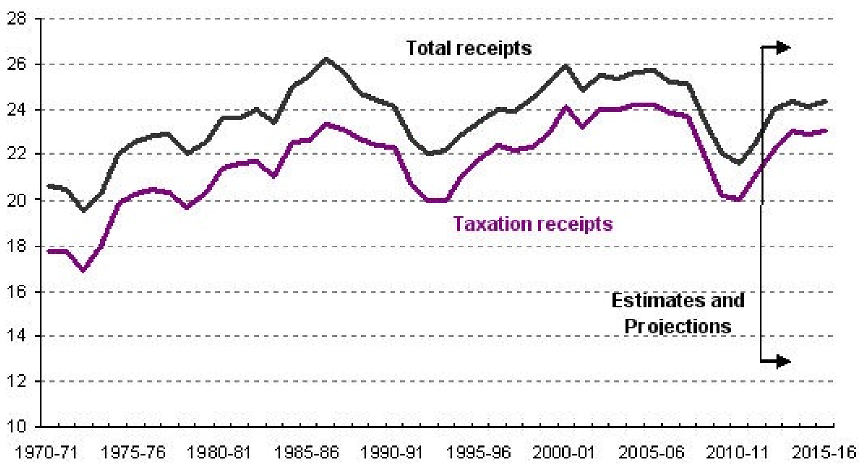
Here in Australia we have our own uncertainties. The hot money that has surged in to bump up our exchange rate could surge out just as easily, producing an exchange rate and inflationary shock. After a period of high rainfall caused by La Nina events, the trend to lower rainfall, almost certainly a manifestation of climate change, has returned, and much of our farming and grazing land is becoming more arid. And then there is election uncertainty, with the possibility of a coalition government.

There was a time when one could reasonably predict the economic policy resulting from a change in government, but this is not the case now, because there are strong and divided factions inside the Coalition. While the Labor factions are about tribal loyalties, the Coalition's factions are ideological — ranging from economic libertarian through to deeply paternalistic, and from global and expansionary through to insularity and opposition to structural change.

Some of Tony Abbott's policies, such as those opposing market-based solutions to climate change, are in strong contrast to traditional Liberal Party policies. His economic policies, to the extent that they have any consistency, are about cutting taxes and resuming the Howard government's path of expanding middle-class welfare. That can only mean deep cuts in health, education and infrastructure — so deep as to create severe disruptions. It is therefore hard to give his policies any credibility. In any case, as the polls creep back up in the government's favour, it is hard to see him holding his position, but Malcolm Turnbull, the only person on the opposition front bench with strong economic credentials, looks unlikely to replace him.

The problem being pushed under the carpet by both the government and the opposition is that Australia has a tax problem, as was borne out in the Budget and as confirmed by the MYEFO figures. To put it simply, we aren't collecting enough revenue to provide the economically important public services required in a developed country. That's why the treasurer has had to scrape around for savings, even in well-justified government programs.

Commonwealth receipts - Percentage of GDP



The Global Financial Crisis dealt a blow to the Commonwealth's receipts. Fortunately, the government applied conventional counter-cyclical management and ran a deficit during this period. That deficit peaked at 10 per cent of GDP, and is now on the way down, thanks to reasonably strong economic growth. Taxation receipts, however, are struggling to what is no more than an anaemic recovery, as is shown in the graph above. With our present policy settings, our taxation receipts will not recover to their levels of earlier this century. The bullish and exuberant conditions of the Howard era, which brought in so much company tax, capital gains tax and GST, were an anomaly, unlikely to be repeated. Indeed, we could do without their recurrence, because these were the very conditions which led to the crisis.

Unless we develop a strong revenue base for the Commonwealth, and, for that matter for the states, future budgets and budget revisions will be repeats of Monday's exercise. It would be naive to expect any proposals before next year's election, but improving our public revenue base, including raising taxes, has to be a priority of whoever is sitting on the treasury benches late next year. Therefore we shouldn't pay too much attention to the MYEFO figures beyond this year. Hard-working public servants in treasury and in line departments put many long hours into preparing them — but they're not worth taking too seriously.