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SELLING AUSTRALIA'S FUTURE:

WHY GOVERNMENT DEBT MATTERS AND HOW TO RETURN TO SURPLUS

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Contents

Key findings

- Between 2007-08 and 2020-21, Commonwealth debt increased from 4.7% of GDP to 42.5% of GDP.
- There is no forecast return to surplus in the Budget. However, modelling in this paper shows the Budget could be returned to surplus within a decade with a reduction in the average annual growth of government spending, from 5.1% to 4%.[1]
- The Budget expects average nominal GDP growth of 5.2% per year between 2023-24 and 2030-31. However, if nominal GDP were to grow at 4.1% per year, which is the same rate as from 2012 (the end of the mining boom) to 2020 (the start of the coronavirus restrictions), then the Budget deficit would blow out to $109 billion by 2030-31. This is more than double the current expected deficit of $45.7 billion.
- Between 2007-08 and 2020-21, Commonwealth debt per person increased over ten-fold, from $3,260 to $33,130 in real terms.
- Interest payments on debt are highly sensitive to changes in interest rates. This paper models three different scenarios for the interest rate on government debt: baseline, downside, and worst case. Both the baseline (2.9% interest rate) and downside (4% interest rate) are based on Treasury forecasts in the Budget. The worst-case scenario (6% interest rate[2]) would entail an interest bill of $64.1 billion in 2030-31 alone. This will make interest payments the third largest expenditure item, behind health and income support for seniors, and equivalent to 7.5% of the Commonwealth budget.

1 This spending does not include payments to states and territories because, as outlined in this paper, that spending is the product of Commonwealth and state agreements, and so is assumed to be fixed.

2 This was the average interest rate on Commonwealth bonds issued in the decade prior to the Global Financial Crisis.

Introduction

Australian Commonwealth and state governments have undertaken drastic measures in response to the public health threat posed by the COVID-19 pandemic. The underlying policy objective was, in the words of Prime Minister Scott Morrison, to "build a bridge to ensure that Australians, Australian businesses, those that are impacted... can get [to the other side of the crisis]".[3]

At the Commonwealth level, building this 'bridge' required significant increases in government spending, most notably through the $101.3 billion JobKeeper wage subsidy and $46 billion expansion of social security and welfare payments.[4] Additionally, the lockdown measures implemented to prevent the spread of COVID-19 caused significant disruption to economic activity resulting in budgeted taxation revenue for the 2020-21 fiscal year to be $48.2 billion lower than expected in the 2019-20 Mid-Year Economic and Fiscal Outlook.[5]

Significant increases in spending coupled with falling tax revenue has caused a surge in government debt. Gross debt in 2018-19 was $542 billion, or 27.8% of gross domestic product (GDP). In 2019-20 gross debt increased to $684.3 billion, or 34.5% of GDP, and is expected to reach 51.5% of GDP in 2023-24 and stabilise at 53% of GDP throughout the remainder of the 2020s.[6]

Higher levels of debt impose significant costs on the economy. These can be broken down into the direct cost of the debt which will be paid off by future taxpayers, the cost of interest payments, the diversion of resources away from the productive sector, the crowding out of business investment, and the economic impact of growing levels of debt.

This paper provides an overview of the government debt situation in the wake of the COVID-19 pandemic and lockdown-induced recession, outlines why this debt burden matters, estimates the cost of interest payments in the year 2030-31, and outlines potential impacts of the debt on GDP.

Australia's high and rising levels of government debt poses a serious risk to future prosperity. Along with imposing direct costs on taxpayers now and in the future, high debt threatens economic stability. In the best interests of all Australians, both living and not yet born, policy makers must make a concerted effort to reduce the debt burden.

3 Scott Morrison, Press Conference, Australian Parliament House, 19 March 2020, https://www.pm.gov.au/media/press-conference-australian-parliament-house-act-10.

4 Commonwealth of Australia, "Budget 2020-21," Budget Paper No. 1, 6 October 2020, https://budget.gov.au/2020-21/content/bp1/download/bp1_w.pdf, pp. 1-13, 6-2.

5 Commonwealth of Australia, "Mid-Year Economic and Fiscal Outlook 2020-21," December 2020, https://budget.gov.au/2020-21/content/myefo/download/myefo-2020-21.pdf, p. 90.

6 Ibid, pp. 56-57.

Current government debt situation

Governments around the world quickly implemented lockdown measures to prevent the spread of COVID-19. These measures required businesses to close, employees to work from home, children to stay home from school, and events and gatherings to be cancelled. In Australia, this strategy was initially implemented in an effort to 'hibernate' the economy and 'flatten the curve'; all but the most essential economic activities would be ceased in an effort to reduce the burden on the healthcare system and ensure adequate public health measures could be implemented without the system being overwhelmed.

This strategy of hibernation has come at a significant cost. Most notably, the Commonwealth government introduced the $101.3 billion JobKeeper wage subsidy to maintain the relationship between employees and their employers and minimise the transaction costs of workers being fired during lockdown and re-hired once the economy was reopened. Additionally, $46 billion has been allocated to expanded social security and welfare payments.[7]

Along with these unprecedented spending measures, lockdowns caused significant disruption to economic activity which has caused taxation revenue for the 2020-21 fiscal year to be $48.2 billion lower than expected in the 2019-20 Mid-Year Economic and Fiscal Outlook.[8]

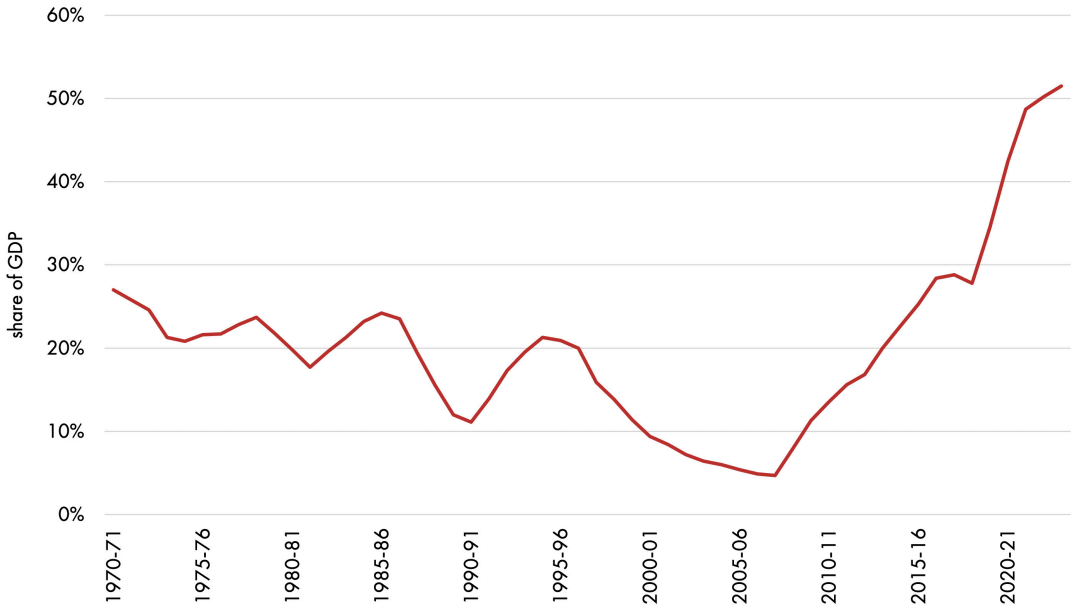
The significant increases in spending coupled with falling tax revenue has caused a surge in government debt. Gross debt in 2019-20 was $684.3 billion, up from $542 billion in 2018-19, and equivalent to 34.5% of gross domestic product (GDP). Debt is expected to increase to 51.5% of GDP in 2023-24 and stabilise at around 53% of GDP throughout the remainder of the 2020s.[9] Chart 1 below shows the level of Commonwealth government debt as a percent of GDP over the past 50 years, including a forecast covering the forward estimates (the three years following the Budget).

7 Commonwealth of Australia, "Mid-Year Economic and Fiscal Outlook 2020-21," December 2020, https://budget.gov.au/2020-21/content/myefo/download/myefo-2020-21.pdf, p. 90; Commonwealth of Australia, "Mid-Year Economic and Fiscal Outlook 2019-20," December 2019, https://budget.gov.au/2019-20/content/myefo/download/MYEFO_2019-20.pdf, p. 118.

8 Ibid, pp. 56-57, 205.

9 Ibid, p. 57.

Chart 1: Commonwealth debt



Source: IPA, MYEFO 2020-21.

Government debt as a share of GDP was trending downward between 1970-71 and 2007-08 but has steadily risen since then. No Commonwealth government has delivered a budget surplus since the final budget of the Howard government, resulting in a growing debt burden.

The current level of government debt as a share of GDP is not unprecedented, however. During the First and Second World Wars, total public debt (including government and public sector debt at the Commonwealth, state, and local level) spiked by one estimate to 205% and 194% of GDP, respectively.[10] While this estimate is based on a different measure from that used in this report, it is indicative of the very high levels of debt incurred in the first half of the 20th century in Australia. However, while some compare the current debt situation to historical levels to argue that high levels of national debt are not unsustainable, this comparison is not accurate. In the post-war period, Australia had very high economic growth compared to recent years. Between 1960 and 1990, the average nominal GDP growth rate was 11.2%.[11] Between 1991 and 2008, this decreased to an average of 6.4%, and further declined to 4.2% from 2009 onward. While some of the high nominal GDP growth in the 1960s-1990s was offset by inflation, high nominal growth coupled with high inflation have a positive effect on the debt position. High nominal growth increases the denominator of the dept-to-GDP ratio, and high inflation erodes the real value of the numerator. As a result, the debt position was rapidly improved after the Second World War.

It is highly unlikely that similar circumstances will work in favour of eroding national debt in the post-COVID-19 environment. As shown above, growth is almost one-third

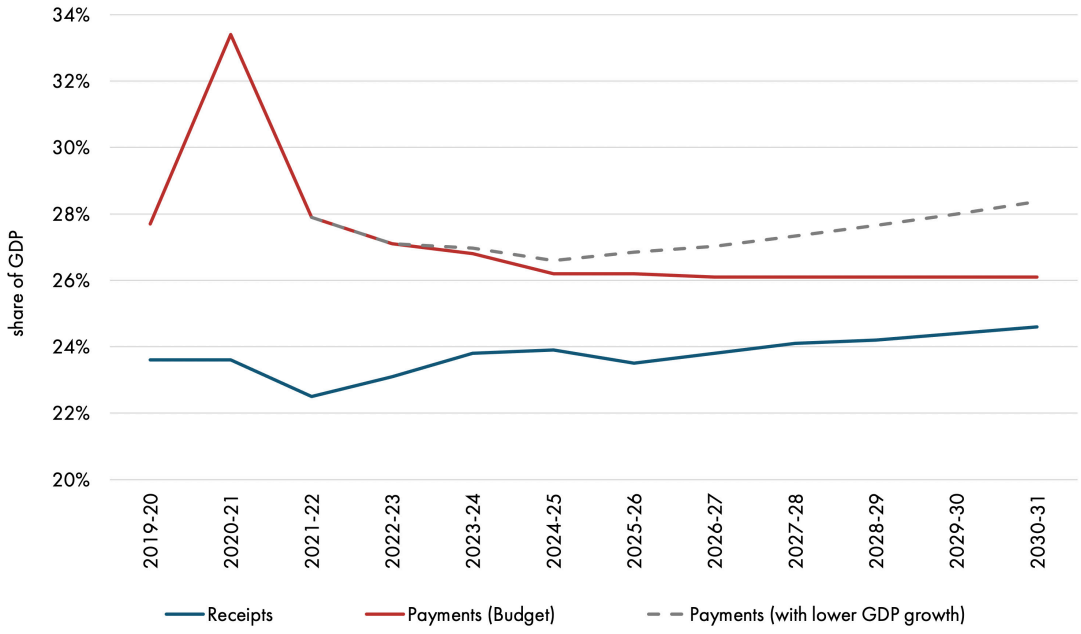
10 Alan Bernard, "Government Finance," in Wray Vamplew (ed.), *Australians, Historical Statistics*, Fairfax, Syme & Weldon Associates Broadway, N.S.W., Australia, 1987, p. 256.

11 Reserve Bank of Australia, "Gross Domestic Product and Income," Statistical Tables, https://www.rba.gov.au/statistics/tables/.

of the 1960-1990 levels, making it harder to pay down debt. This makes it vital that governments address the debt issue; it will not simply inflate itself away, and it is unlikely Australia will be able to outgrow it.

The medium-term forecasts in the Mid-Year Economic and Fiscal Outlook (MYEFO) show gross debt to GDP stabilising at 53% throughout the second half of the 2020s. There is no forecast return to surplus in the medium-term estimates. Chart 2 shows the Budget estimates of government payments and receipts as a percentage of GDP. The gap between payments and receipts represents the size of the budget deficit. Government payments are forecast to stabilise at approximately 26.2% of GDP from 2024-25 with receipts ranging between 23.5% and 24.6% of GDP. The government has maintained its commitment to keeping taxation receipts below 23.9%. This means that the deficit in 2030-31 of 1.5% of GDP cannot be closed without reductions in spending or increases in non-taxation receipts.

Chart 2: Government receipts and payments with lower GDP growth

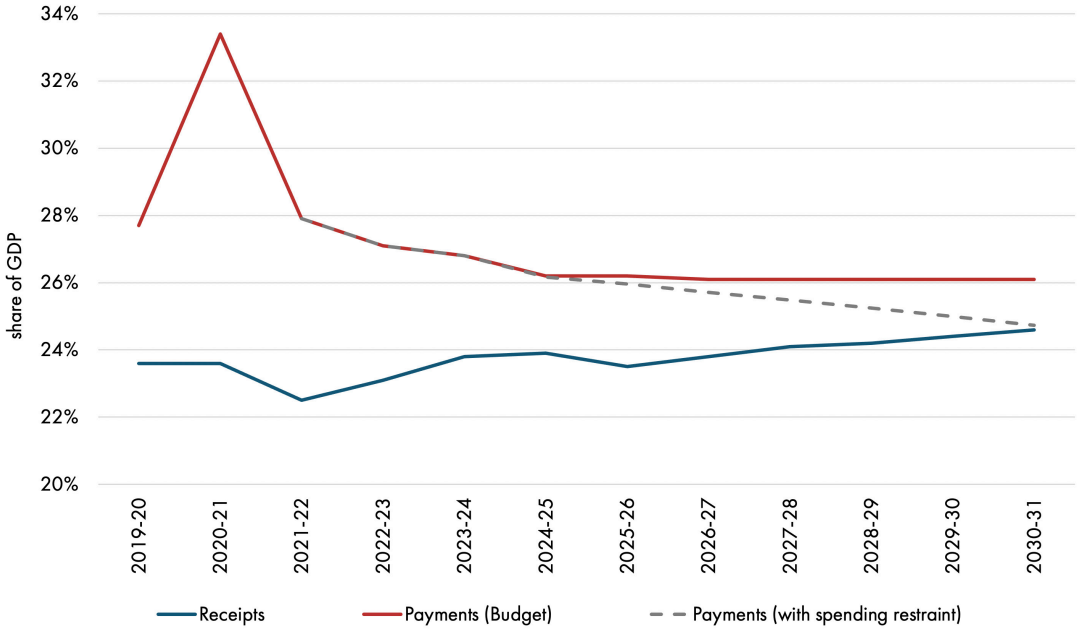


Source: IPA, MYEFO 2020-21.

The reduction in the size of the deficit is dependent on nominal GDP growth. The forecast set out in the MYEFO is based on estimates of nominal GDP growth falling to 1% in 2020-21, increasing to 4.75% in 2023-24, and growing steadily thereafter with the nominal growth rate assumed to increase to 5.5% in 2030-31. Lower nominal GDP growth over the next decade could prevent the forecast deficit reduction. For example, if nominal GDP growth averaged 4.1% as prevailed between the end of the mining boom in 2012 and 2019, before the pandemic, current spending forecasts would see payments reach 28.4% of GDP by 2030-31 and the size of the deficit growing rather than contracting. This scenario is shown in Chart 2 by the grey dotted line, with the deficit reaching $109 billion in 2030-31.

Gross debt to GDP ratios can be maintained or even lowered while running budget deficits. But for this to happen, the nominal GDP growth rate must exceed the growth rate for gross debt. Weaker than forecast GDP growth would see debt to GDP rise and would also likely put upward pressure on social security and welfare payments due to higher rates of unemployment, putting further strain on the budget position by increasing deficits.

Chart 3: Government receipts and payments with spending restraint



Source: IPA, MYEFO 2020-21.

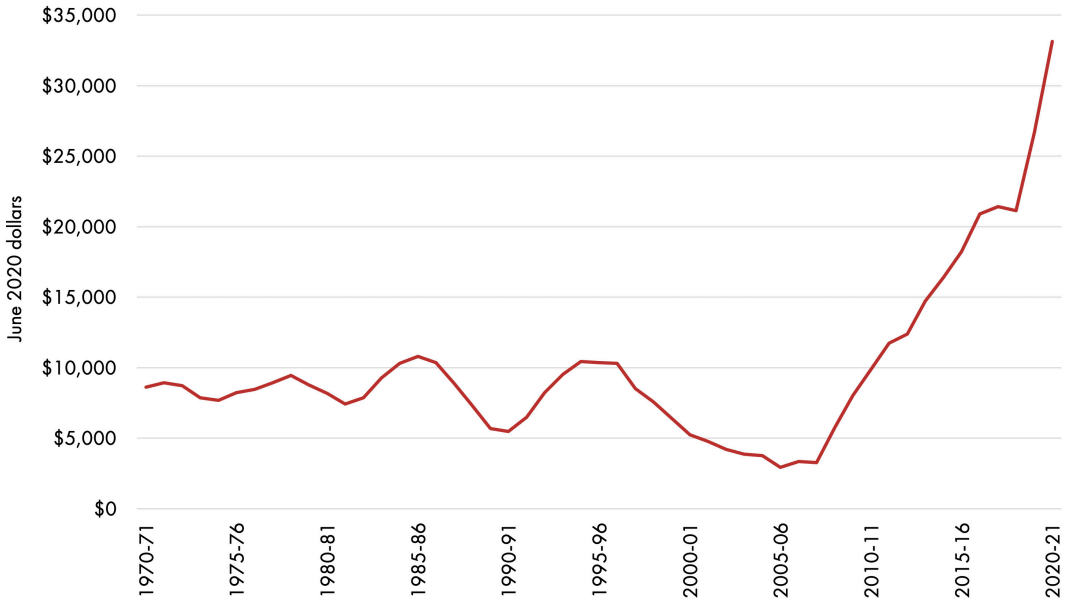
Returning the Budget to surplus can be achieved with spending restraint over the next decade. The Budget forecasts spending in nominal terms to grow by an average of 5% per annum from 2024-25 to 2030-2031. The grey dotted line in Chart 3 shows payments as a percentage of GDP if the Commonwealth government commits to reducing the growth in spending to 4.1% per year from 2024-25, excluding payments to the state and territories. State and territory payments are excluded as these payments are based on agreements between the Commonwealth government and the states and territories where the Commonwealth government has reduced discretion for restraining spending. This modest reduction in spending growth would see a return to surplus in 2031-32.

Why debt matters

Government debt imposes significant costs on taxpayers both now and in the future. There are five ways that debt can negatively impact taxpayers.

Firstly, debt must be paid off by taxpayers at some point in the future. This requires either higher levels of taxation, reducing wealth and income, or lower levels of government spending. By increasing debt today, the government is effectively borrowing from the wealth of future generations to pay for current expenditure. Some argue that this does not necessarily matter because the debt will be repaid to future bondholders, many of whom are Australian residents. According to figures from the Australian Office of Financial Management, however, non-residents currently own 53.1% of Commonwealth government bonds on issue, and since 2003 non-residents have owned an average of 61.1% of Commonwealth government bonds.[12] So higher levels of government debt are not just a transfer of wealth from future generations to the current generation, but a transfer of wealth from Australian residents of the future to non-residents of the future. Chart 4 below shows the amount of Commonwealth debt per Australian, which has increased more than ten-fold from $3,260 in 2007-08 to $33,130 in 2020-21.

Chart 4: Commonwealth debt per person



Source: IPA, MYEFO 2020-21, ABS.

Secondly, interest payments impose an ongoing cost on taxpayers until the total debt is paid off. In the 2020-21 Budget, interest payments are expected to cost $17.2 billion or 2.6% of total government expenditure. Some argue that this is a relatively small cost for maintaining a large debt, and that because interest rates are currently low the

12 Australian Office of Financial Management, "Non-resident Holdings of AGS," Data Hub, Commonwealth of Australia, https://www.aofm.gov.au/data-hub.

level of debt does not matter. There are two main reasons why this argument is flawed, however: interest payments pose a significant opportunity cost which prevents increased spending or lower taxes elsewhere, and interest rates will rise long before Australia is able to pay off this debt meaning that interest payments will grow substantially. The cost of interest payments and the sensitivity of these payments to rising interest rates are explored further in the section *Cost of Interest Payments in 2030-31* below.

Thirdly, funding government spending through issuing government debt removes the political restraint on wasteful government spending. When spending is funded by current taxation, increasing spending means raising taxes on the electorate. Deficit spending removes this restraint and obscures the opportunity cost of government spending.

All government spending, regardless of how it is funded, removes resources from the private productive sector of the economy and applies them toward politically determined ends that are not proven valuable by a profit and loss system. Government spending is subject to the calculation and knowledge problem as developed by Ludwig von Mises and F.A. Hayek.[13] While government spending can be directed toward beneficial ends, there is a real opportunity cost of government spending that is easy to ignore. For example, the creation of public sector jobs removes workers from the private sector where they could be more profitably employed, government construction projects bid away resources from private construction, and government redistribution measures shift resources away from wealth creators to the receivers of government payments.

Fourthly, the issuance of government debt puts upward pressure on interest rates that can crowd out private investment and negatively affect economic growth. Increasing the supply of government bonds lowers the price of bonds and increases the yield. Holding all else constant, higher interest rates on government bonds will put upward pressure on business loan interest rates, thus reducing business investment. This negative effect is currently being mitigated by the Reserve Bank of Australia's commitment to maintain low interest rates through monetary expansion to purchase government bonds on the secondary market. Pursuing this policy has already seen the RBA's balance sheet expand by over 70% since 2019 to $300 billion.[14] If this monetary expansion leads to price inflation, the RBA may be forced to abandon their bond buying activity and allow interest rates to increase with negative ramifications on business investment.

Finally, growing levels of debt reduce economic activity, leading to higher unemployment, lower wages, and fewer opportunities. There is some evidence that increasing levels of debt as a share of GDP can cause a drag on growth. Some argue that Australia's debt burden is not a cause for concern because it is relatively lower than many other developed countries. However, this is a misleading claim as it does not take into account the direction of government debt, which has been increasing steadily since the 2008-09 fiscal year.

13 Ludwig von Mises, "Economic Calculation in the Socialist Commonwealth," Ludwig Von Mises Institute, Auburn University, 1990; Friedrich A. Hayek, "The Use of Knowledge in Society," *The American Economic Review*, vol. 35, no. 4, 1945, pp. 519-530.

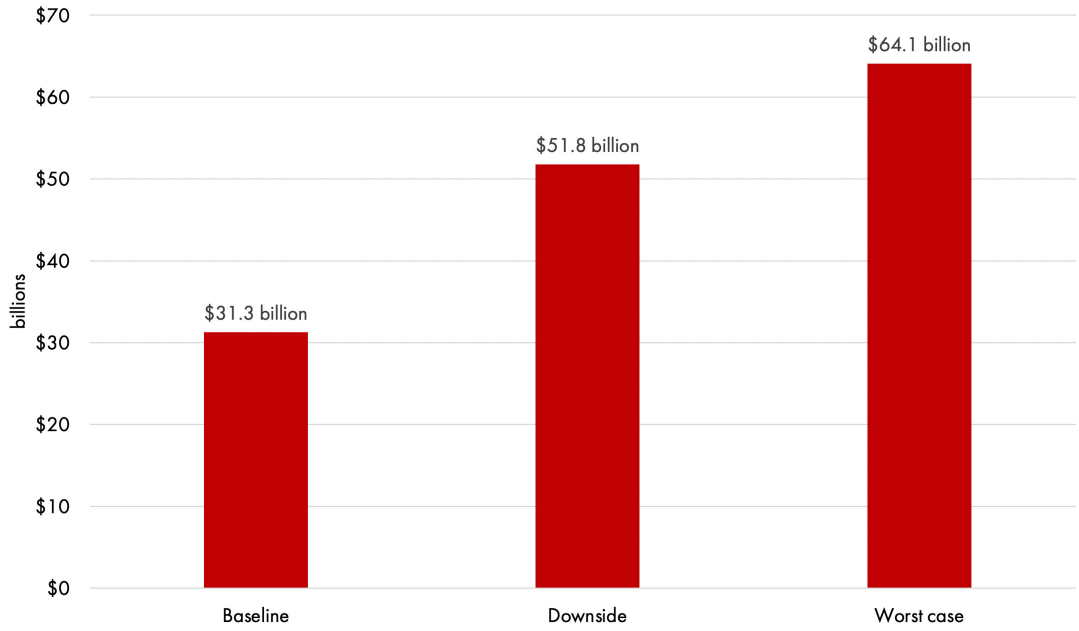
14 Reserve Bank of Australia, "Statement of Liabilities and Assets," https://rba.gov.au/statistics/frequency/stmt-liabilities-assets.html.

Cost of interest payments in 2030-31

Modelling undertaken for this report provides three different scenarios for interest payments in the year 2030-31. The different scenarios are based on different assumptions about what the effective interest rate on Commonwealth government debt is. The baseline and downside scenarios are based on assumptions set out by Treasury in the 2020-21 Budget, while the worst-case scenario is based on a situation where interest rates rise faster than Treasury expects to the average seen on 10-year government bonds in the decade prior to the global financial crisis. The interest rate for new debt remains at 0.9% between 2020-21 and 2023-24, before rising to 2.9% under the baseline scenario, 4% under the downside scenario, and 6% under the worst-case scenario, by the year 2030-31.

Commonwealth government debt is expected to cost between $31.3 billion and $64.1 billion to service in the fiscal year 2030-31. The estimates are shown in Chart 5 below.

Chart 5: Interest payments on Commonwealth debt in 2030-31



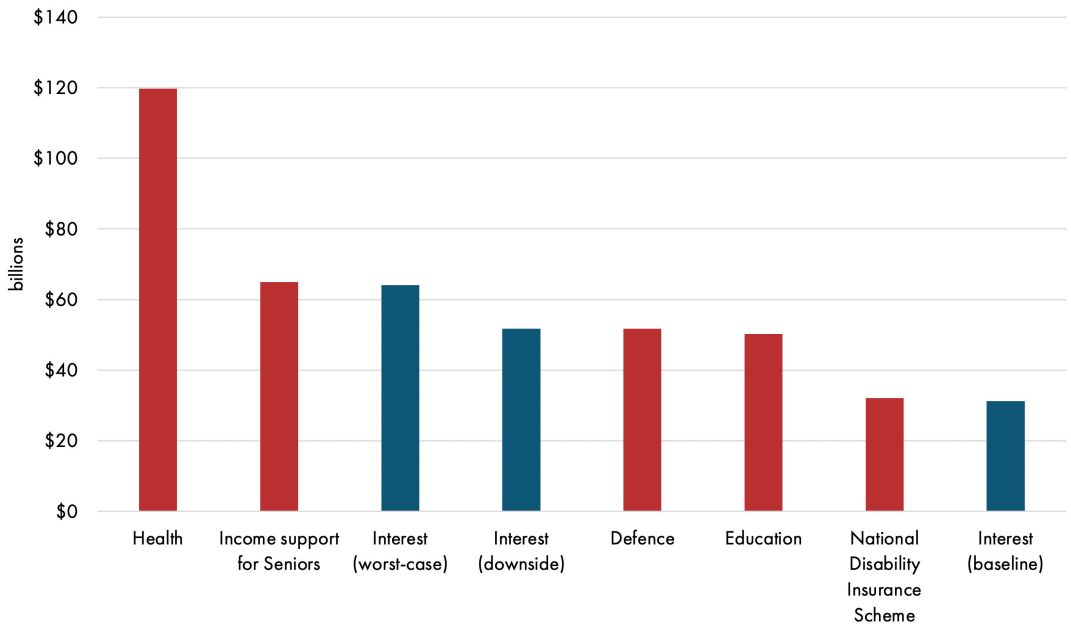
Source: IPA.

The effective interest rate on Commonwealth government debt is influenced by the range of bonds currently on offer and the interest rate that those bonds are subject to. For example, if half the debt was issued when interest rates were 0.8% and half when they were 2%, this would yield an effective interest rate of 1.4%. As bonds mature, unless the government can pay the principle, they are rolled over into new debt at a new interest rate. While Treasury expects all debt issued between 2020-21 and 2023-24 to have an interest rate of 0.9%, they predict that interest rates will increase

after that.[15] How rapidly they rise, and what rate they rise to, will influence the effective interest rate by increasing the cost of borrowing for maturing bonds where the debt needs to be rolled over.

Spending on interest payments will comprise a large part of the Commonwealth budget in future years. Chart 6 below places the three interest scenarios above into the context of forecast Commonwealth spending in other areas. The baseline forecast for interest spending in 2030-31 is likely to be comparable to the entire National Disability Insurance Scheme budget in that year. The downside forecast for interest spending is slightly higher than the total Defence budget in that year. And the worst-case forecast for interest spending it equivalent to all spending on Income support for Seniors. Additionally, the worst-case scenario would see the Commonwealth spending the equivalent of 61% of the total Health budget on servicing debt.

Chart 6: Commonwealth expenses in 2030-31

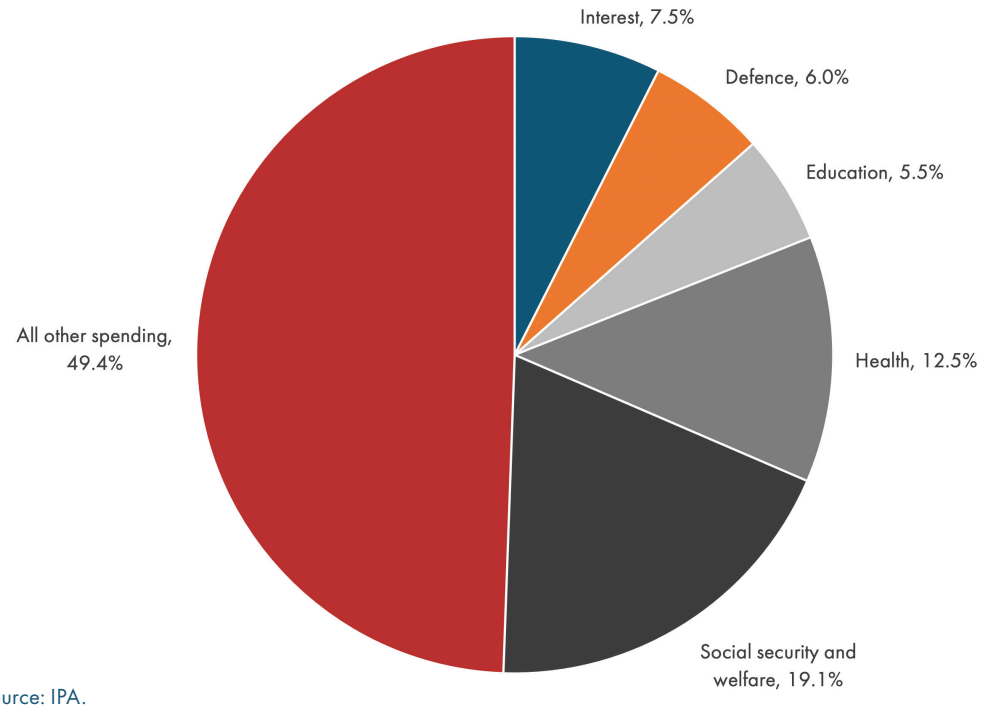


Source: IPA.

15 Commonwealth, "MYEFO 2020-21," p. 66; Commonwealth, "Budget 2020-21," p. 7-17.

Chart 7 below places the worst-case scenario spending on interest into the context of the 2030-31 Budget, showing that interest spending will comprise 7.5% of all Commonwealth spending and be a larger portion of the Budget than both total Defence spending and total Education spending.

Chart 7: Components of Commonwealth budget in 2030-31



Source: IPA.

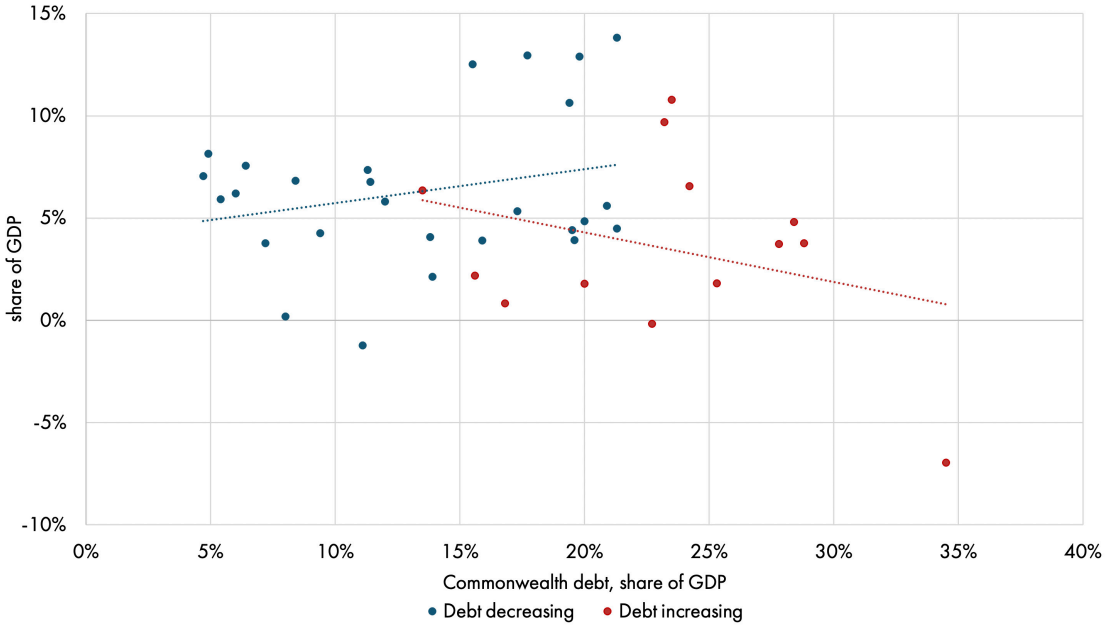
Impact of debt on economic growth

There is some evidence that the direction of government debt can impact economic growth. Arguments that Australia's level of debt as a share of GDP relative to other countries is low, and therefore not of concern, do not take into account that the direction of debt can negatively impact future economic growth. As shown in Chart 1 above, Australia's debt-to-GDP ratio has increased steadily since the 2008-09 fiscal year.

Following the methodology set out by economists at the International Monetary Fund,[16] Chart 8 below shows the relationship between gross debt as a share of GDP and GDP growth per capita, based on a 10-year debt trajectory. This provides support for the argument that Australia's increasing debt burden may cause economic growth to slow. In years where gross debt is higher as a share of GDP than it was 10 years prior, economic growth is usually lower. And when gross debt is lower as a share of GDP than it was 10 years prior, economic growth is usually higher.

There are several explanations of why growing debt burdens can have a negative impact on GDP growth. As summarised in a paper by researchers from the International Monetary Fund and Switzerland's Department of Economics, public debt can have a negative effect on growth if it reduces the productivity of government spending, increases uncertainty, creates an expectation of higher taxes in the future, or increases sovereign risk.[17]

Chart 8: Commonwealth debt and economic growth



Source: IPA, Budget 2020-21, ABS.

16 Andrea Pescatori, Damiano Sandri, and John Simon, "Debt and Growth: Is There a Magic Threshold?," International Monetary Fund, February 2014, https://www.imf.org/en/Publications/WP/Issues/2016/12/31/Debt-and-Growth-Is-There-a-Magic-Threshold-41352.

17 Ugo Panizza and Andrea F. Presbitero, "Public debt and economic growth: Is there a casual effect?," *Journal of Macroeconomics*, vol. 41, 2014, p. 21.

Conclusion

The policy response to COVID-19 has caused a collapse in taxation receipts coupled with a rapid increase in government spending. As a result, Commonwealth government debt will reach over $1.06 trillion, or 50.2% of GDP, by the 2022-23 financial year. Modelling conducted by the Institute of Public Affairs highlights that gross debt is likely to peak at $2.05 trillion in 2044-45.[18]

While Commonwealth government debt as a share of GDP reached higher levels during the Second World War, the increase was rapid and short-lived. Prior to COVID-19 arriving in Australia gross debt was increasing rapidly as a result of fiscal irresponsibility.

High levels of government debt transfer wealth from future generations to those alive now, and the costs of servicing that debt increase burdens on both current and future taxpayers while posing an opportunity cost which inhibits governments from either spending in other areas or reducing the tax burden. Government spending which increases debt removes the constraint on wasteful spending, and doing so removes resources from the productive, private economy and places upwards pressure on interest rates with the effect of crowding out private sector investment. Increasing levels of debt also depresses economic growth, which compounds the effect of high debt levels by making it relatively harder to pay off.

In addition to causing these direct and indirect costs, sustained levels of high debt leave the Commonwealth Budget in a precarious position when future shocks arise. Australian governments should prioritise fiscal responsibility and debt management to ensure that Australians are well placed to weather the uncertain times ahead. By keeping debt levels low, governments are better placed to respond to crises that are yet to arrive. All Australians should be concerned with the high level of government debt; it is them, their children, and their grandchildren who will be paying for it.

18 Cian Hussey, "Debt to Hit $2.05 Trillion, 60 Years to Pay Off," Institute of Public Affairs, 7 October 2020, https://ipa.org.au/ipa-today/debt-to-hit-2-05-trillion-60-years-to-pay-off.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