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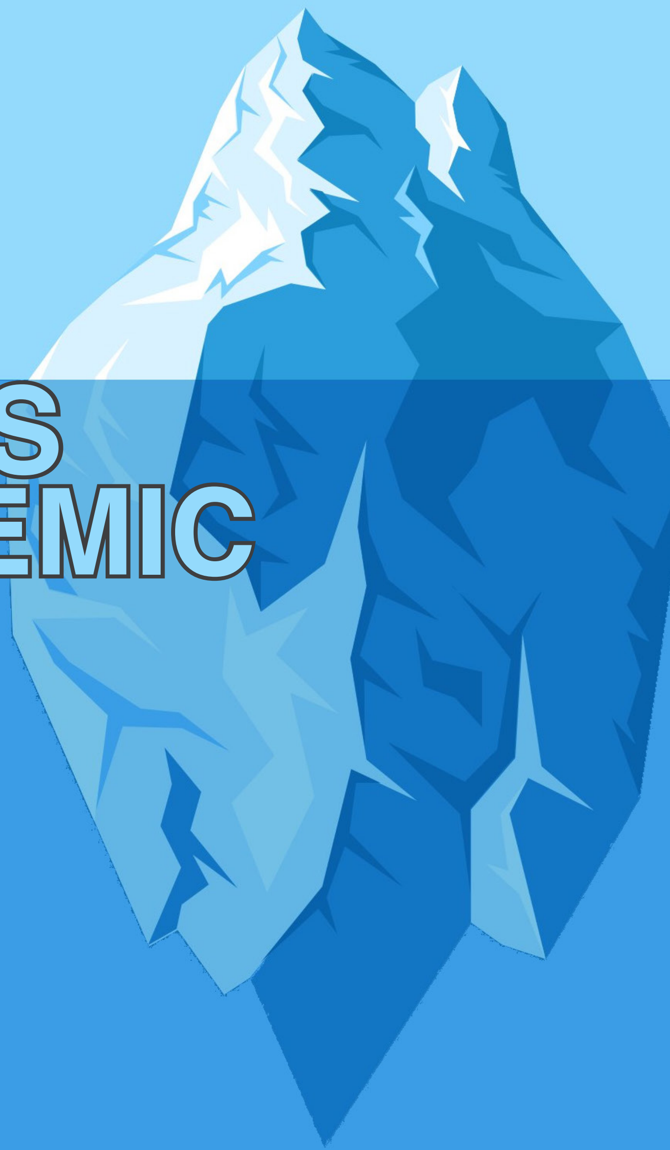

THE LOOMING ICEBERG: AUSTRALIA’S POST-PANDEMIC DEBT RISK

Robert Carling

CIS Pandemic to Prosperity

THE CENTRE FOR INDEPENDENT STUDIES

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The Looming Iceberg: Australia's post-pandemic debt risk

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Contents

Key points

- Australia's increased debt burden poses a risk to economic growth in the longer term and reduces fiscal flexibility and the capacity to respond to future crises.
- After many years with low public debt, Australia is seeing a much higher debt burden as a result of the coronavirus pandemic. In the years ahead, it will reach levels (relative to the size of the economy) last seen in the early post-World War II years.
- Much of the increase since the pandemic has been unavoidable, but reversing the increase should be a policy priority once its underlying causes have passed.
- The confidence often heard expressed that the debt burden will be manageable in the long-term should be heavily qualified. A steep decline in the debt burden such as was seen after World War II will depend on vigorous economic growth, continuing very low interest rates and the exercise of fiscal discipline, none of which is assured.
- The increase in debt is happening at both Commonwealth and state/territory levels of government.
- From very low levels (and negative in net terms) before the global financial crisis, debt had already risen significantly by 2019. At the Commonwealth level it was then set to decline as a result of budget surpluses, but at the state level it was set to surge mainly as a result of increased infrastructure investment.
- The effect of the pandemic will be to turn the previously projected shrinkage of Commonwealth debt into rapid expansion over several years and to add substantially to the previously projected growth of state debt.
- Based on the recent round of 2020/21 budgets and forward estimates to 2023/24, general government gross debt is projected to balloon from $817 billion in June 2019 (42% of GDP) to $1,755 billion in June 2024 (80% of GDP). On a net debt basis the increase is from 22% of GDP to 61%.
- The comparison between the latest and previous projections suggests that the pandemic effects will add around 40% of GDP to debt (more than $800 billion) within a few years, which largely accounts for the total projected increase. Longer term projections suggest this impact will widen further after 2024.
- The increase in debt from the pandemic is due in large part to net operating deficits (the cost of current government services exceeding current revenue) totalling $515 billion at the Commonwealth level and $120 billion at the state level over the five years to 2023/24, rather than to investment in infrastructure.
- Broader measures of indebtedness such as net financial liabilities (which include unfunded superannuation) are some $430 billion (20% of GDP) higher than debt alone in 2024. General government net financial worth, already substantially negative, will become much more so.
- The broadest measure of state net debt – that of the non-financial public sector, which includes government business enterprises – is set to soar in all states and territories except WA, and will be well above 100% of a year's operating revenue in all except WA and TAS. The largest increase in net debt, the highest projected level, and the largest net operating deficit are all in Victoria, but other states and territories except WA are also expecting large deficits and increases in debt.
- NSW and VIC have already suffered downgrades to their previous AAA credit ratings since their budget announcements, and further downgrades in those and some other states and territories would not be surprising.

Introduction

One of the major economic policy issues of the times is the growth of public debt in the wake of the coronavirus pandemic and what this growth means for the future. Some economists believe the burden will be manageable. Others express varying degrees of concern.

What are the dangers of the higher debt burden?

- Such a large increase in indebtedness as is now under way cannot occur without consequences such as reduced fiscal flexibility and capacity to respond to future crises; and a drag on growth in the longer term, even if increased deficits are stimulatory in the short term.
- The confidence often heard expressed that the debt burden will be manageable in the long-term should be heavily qualified. A steep decline in the debt burden such as was seen after World War II will depend on vigorous economic growth, continuing very low interest rates and the exercise of fiscal discipline, none of which is assured. Long-term projections based on existing policies point to a persistent structural deficit, elimination of which will need to be an early policy priority once the pandemic abates.

But before coming to a judgement about these implications, we need to know the likely size of the increase and to put it into historical perspective. That is the main focus of this report.

The fiscal landscape has changed dramatically and rapidly since March 2020, and for several months it was difficult to quantify the effects on government budgets. The much delayed delivery of Commonwealth and state/territory budgets in recent months now makes it possible to construct a comprehensive picture of the debt outlook up to 2024. This includes the updated Commonwealth 2020/21 budget estimates released in the mid-year review in December.

The national debt outlook

Although the Commonwealth budget is by far the largest and often the focus of attention, it is important also to examine states and territories as they are large borrowers in their own right. State and territory budgets with the exception of the ACT were announced between early October and early December. (The ACT budget is expected in early 2021, but because of its relatively small size will not make much difference to the national aggregates.)

These budgets provide estimates for the 2020/21 budget year and forward estimates up to 2023/24. The estimates are of diminishing reliability the further ahead the horizon, but the figures for the later years are the best available and despite the qualifications attaching to them, they still provide an approximate guide to where debt is headed in the medium term.

The estimates portray a picture of rapidly rising public debt, as detailed in the following series of graphs.

Figure 1: General Government Net Debt (as % of GDP)

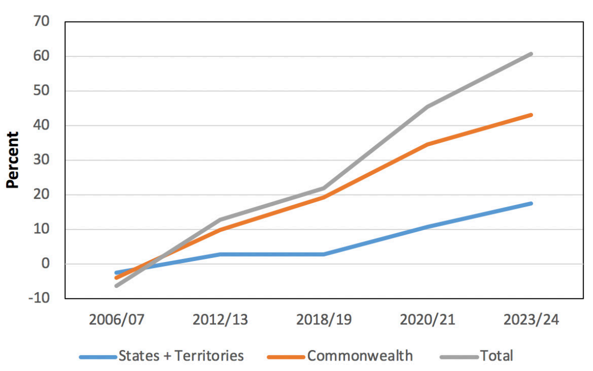


Figure 2: General Government Gross Debt (as % of GDP)

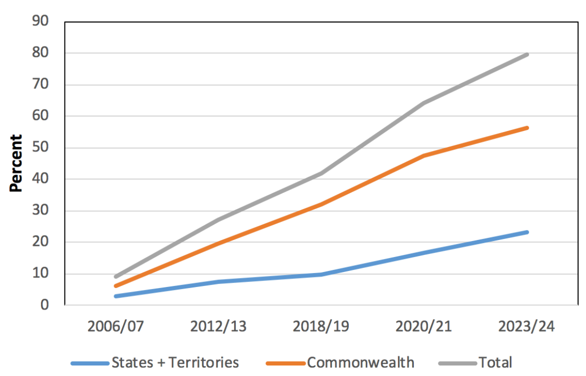


Figure 3: General Government Gross Debt ($ billion)

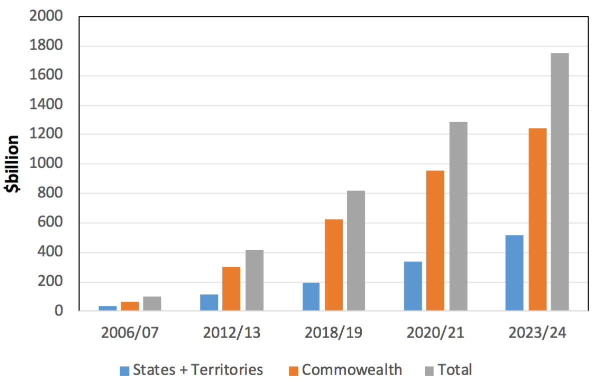


Figure 4: Non-financial Public Sector Gross Debt (as % of GDP)

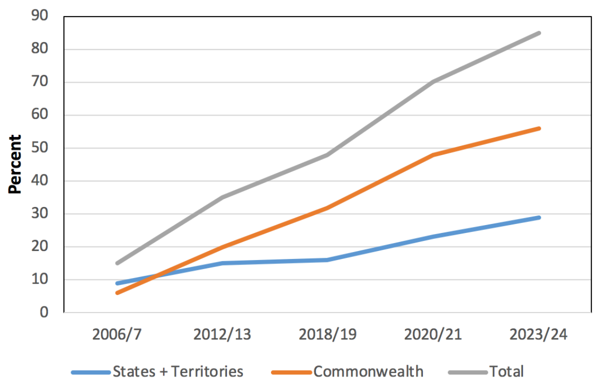


Figure 1 shows total general government net debt as a percentage of GDP and its Commonwealth and state/territory components. Net debt was negative before the global financial crisis but has grown continuously since then. Up to 2018/19, most of the growth was at the Commonwealth level, but since then state and territory debt has also started to increase rapidly. Particularly large increases in 2019/20 and 2020/21 result from the deficits associated with the pandemic and the fiscal policy responses to it. Net debt — the measure most often used to gauge the debt burden — is estimated to reach around 60% of GDP in 2023/24, almost triple its level of 22% before the pandemic. This will be the highest level on record, although the historical data for net debt are limited.

In gross terms, general government debt will rise from 42% of GDP before the pandemic to a peak of around 80% in 2023/24. This is the highest level since the early 1950s, when the debt burden was falling steadily from its Second World War peak of over 100% of GDP. In dollar terms, general government gross debt in 2023/24 is projected to be some $1.75 trillion, comprising around 70 cents in the dollar Commonwealth and 30 cents state/territory. This measure of debt was well below $1 trillion immediately before the pandemic and below $500 billion as recently as 2014.

Estimates are also available for the non-financial public sector, which is broader than the general government sector as it also includes public trading enterprises such as water supply utilities. On this broader measure, both net and gross debt will be roughly $130 billion — or 6% of GDP — greater than general government debt. In dollar terms, gross debt will reach around $1.9 trillion, or around 85% of GDP, in 2024, having been below $1 trillion before the pandemic and below $500 billion in 2012.

Most public trading enterprise debt resides in the state/territory sector. In net terms, state/territory non-financial public sector net debt is projected to reach around 23% of GDP, which will exceed the previous measured peak below 20% in the early 1990s, when some states were under severe financial stress due to the failure of state-owned banks.

State comparisons

The second set of graphs focuses on the states and territories and enables comparisons among them.

Figure 5: General Government Net Debt of States and Territories

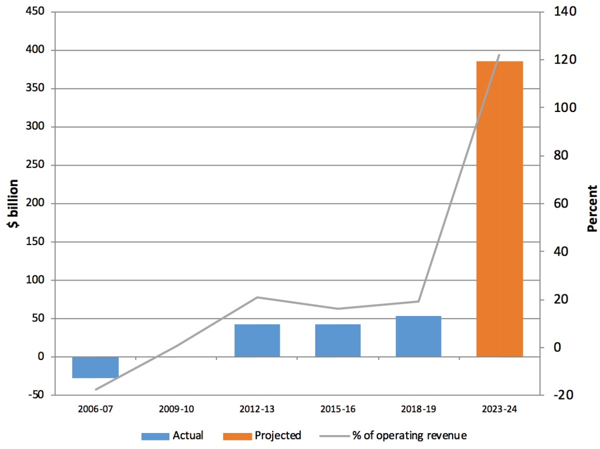


Figure 6: General Government Net Financial Liabilities of States and Territories

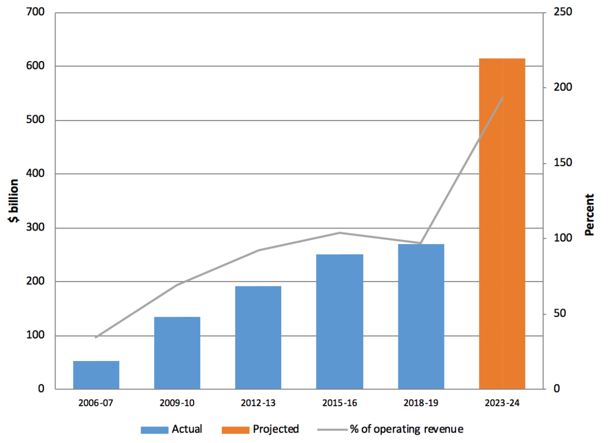


Figure 7: Non-financial Public Sector Net Debt of States and Territories

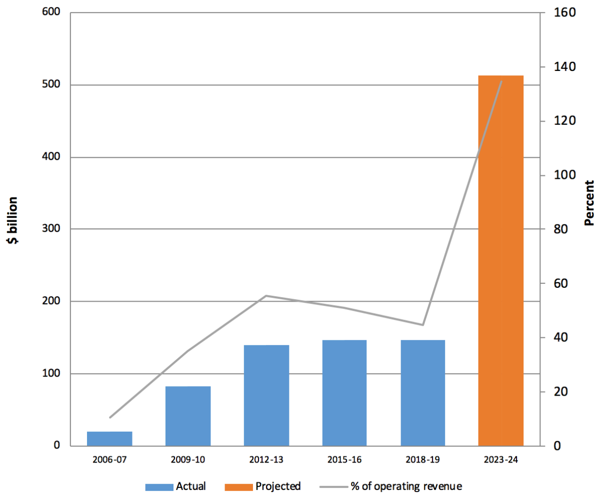
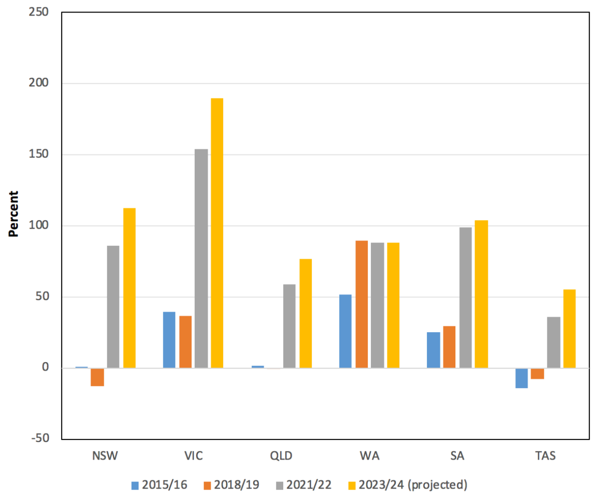


Figure 8: General Government Net Debt of States (as % of operating revenue)



Figures 5 – 7 show three measures of net debt and net financial liabilities for the general government and non-financial public sectors of the states and territories in aggregate. These graphs show the more meaningful measure of state debt as a percentage of budget operating revenue rather than GDP.

Clearly on all measures net debt was low in 2006-07, increased somewhat up to 2019, and is projected to increase very sharply up to 2023-24, when net debt will far exceed 100% of a year's operating revenue. (In fact this position will be reached in most states and territories before 2023-24.) This represents a substantial weakening of state and territory fiscal positions and it is not surprising that one credit rating agency has stripped both NSW and Victoria of their AAA ratings since their budget announcements.

These aggregates conceal significant variation among the states, the detail of which is shown in figures 8 – 10. On all the measures shown here, all states except WA are estimating a major increase in debt and net financial liabilities. Victoria is the state with the highest expected debt ratios by 2024, and the largest increase from the pre-pandemic position in 2019. This also stands if the two territories are included in the comparison. However the NT in particular, although expecting slightly lower debt burdens than Victoria, has less capacity to service debt and could be considered to be in the weakest position, as reflected in its low credit rating.

NSW is in a stronger position than Victoria, but exhibits the second largest increase in debt burdens which will transform its fiscal position from one of outstanding strength in recent years to one that is more in line with the average of the states.

Figure 9: Non-financial Public Sector Net Debt of States (as % of operating revenue)

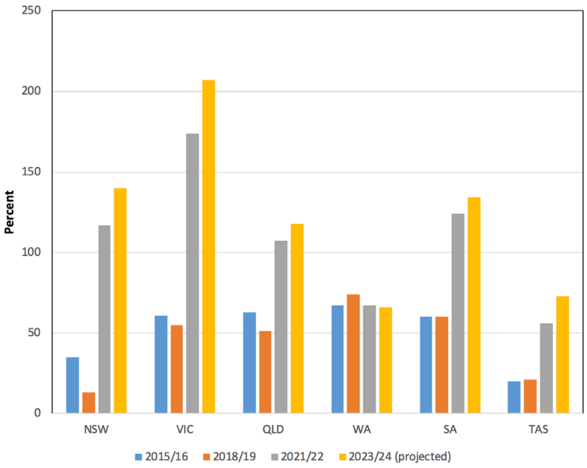
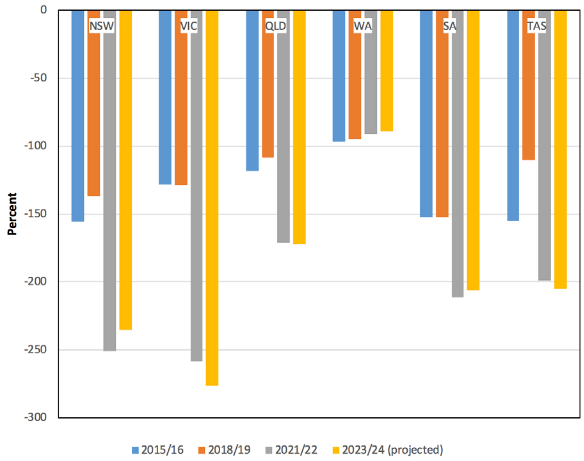


Figure 10: Non-financial Public Sector Net Financial Worth of States (as % of operating revenue)



Source of the increase in debt

Data pointing to growing debt on their own reveal nothing about the causes, and in particular whether the debt is financing capital or recurrent expenditures.

The increase in Commonwealth debt is largely due to a recurrent deficit. The Commonwealth's total net operating deficits are estimated at $515 billion over the five years beginning with 2019/20. This is not surprising, as the Commonwealth budget is dominated by recurrent expenditure and revenue flows that are sensitive to economic conditions, while capital expenditure is relatively small.

The situation of the states is different in that recurrent flows are less sensitive to the economy and capital expenditure is relatively large. In the past, states have generally adopted the principle that net operating budgets should be in surplus, which means that the cost of current services is being fully funded by current revenue with a margin above that to contribute to the financing of infrastructure -- particularly social infrastructure, which does not produce a financial return. A surplus of operating revenue over operating expenses has been seen as an important indicator of the financial sustainability of current services.

States have generally passed this fiscal test. Data extending back to the late 1980s show that while some states have occasionally dipped into a net operating deficit for limited periods, this has been exceptional. Figure 11 shows that from the mid-2000s until 2018-19, there was only one year in which states in aggregate recorded a net operating deficit -- namely 2012-13.

Figure 11: Net Operating Balance, States & Territories ($ billion)

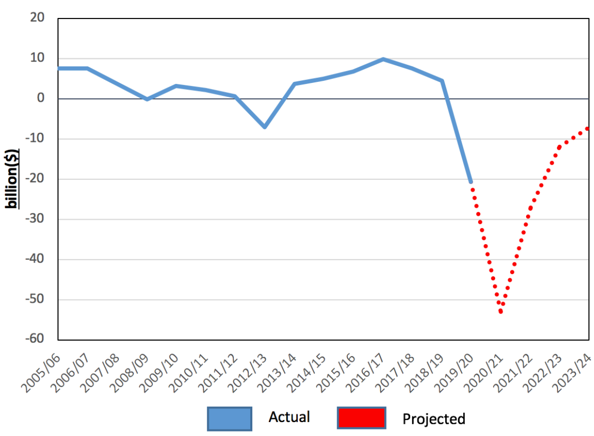
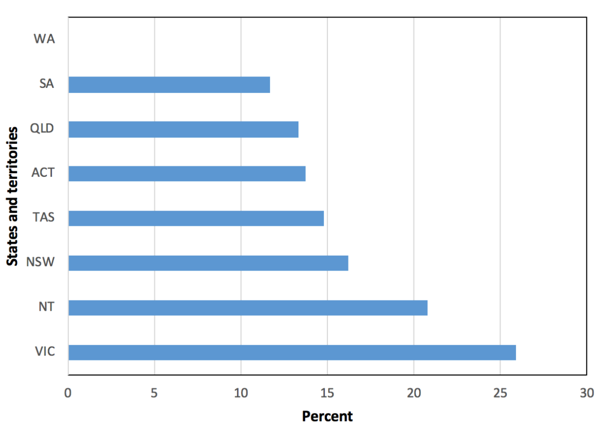


Figure 12: States and Territories Net Operating Deficit (as % of operating expenses, 2020/21)



In stark contrast, the aggregate net operating result plunged to a deficit of $21 billion in 2019-20 and is estimated to reach $53 billion in the current financial year before slowly shrinking, but remaining in deficit throughout the forward estimates period to 2023/24. WA is the only state reporting net operating surpluses each and every year. Among the other states and territories, the only exceptions to five years of operating deficits are the small surpluses estimated by SA and TAS by 2023-24.

In aggregate, over the five years 2019-20 to 2023-24 state and territories are estimating operating deficits totalling $120 billion. This is unprecedented in the recorded history of state finances and does not augur well for fiscal sustainability. It means that 37% of the projected total increase in state general government debt over those five years will finance net operating deficits rather than infrastructure.

Figure 11 reveals which states have gone farthest into deficit by showing the net operating deficit as a percentage of total operating expenses in the peak deficit year, 2020-21. Not surprisingly, Victoria is the leader at 26%, but all the states other than WA are also financing a significant proportion of operating expenditure out of borrowings.

Discussion of issues

The pandemic has seriously weakened Australia's public finances. The days of Australia's unquestionably strong public finances have passed. Debt had increased substantially even before the pandemic, but is increasing much further in its wake. The previously strong position left Australia's public finances well placed to handle a crisis, but we are now in a weakened position to respond to another crisis beyond the current pandemic. Even if the public finances are eventually repaired, the next crisis may well come before that happens. It is of little comfort to know that some other developed countries, such as the US, Japan and the UK, have even higher public debt. The Australian exceptionalism that came with low levels of public debt has gone for the foreseeable future.

Such a large increase in indebtedness as is now under way cannot occur without consequences. At the very least, it raises the nation's economic risk profile. It leaves Australia more vulnerable to future adverse shocks. More tangible is the drag on economic growth and the loss of public policy opportunities that would otherwise have been available. The impact of a public debt burden on economic growth is a controversial issue among economists. Large deficits may be stimulatory in the short-term but the resulting debt burden may also act as a drag on economic growth in the medium to long term. However, there is much dispute about the level of debt at which a negative impact on growth begins to be felt.

It is clear that debt will restrict future fiscal flexibility. Future tax cuts will have to be foregone or taxes increased. While there will be a welcome increase in discipline on governments to avoid wasteful spending, fiscal pressure will also crowd out beneficial new spending, including on infrastructure. Once the current crisis passes and governments focus – as they inevitably must – on budget repair, this task will be a distraction from the equally important challenge of implementing reforms to strengthen productivity growth.

Comparisons between current and pre-pandemic estimates of future debt provide a measure of the fiscal cost of the pandemic. For the Commonwealth, a recent Parliamentary Budget Office report calculates the increment in net debt in 2023-24 to be around 30% of GDP.[i] This widens further to around 40% of GDP in 2030-31, when net debt was previously projected to be almost zero.

For the states, there are no comparable projections to 2030, but analysis of pre- and post-pandemic budget papers suggests an impact of around 10% of GDP within a few years.

We can therefore say that looking at the Commonwealth and states in aggregate, the pandemic will result in net debt being about 40% of GDP higher than otherwise within a few years. This staggering amount – more than $800 billion – results from increased government expenses and the loss of revenue from weaker economic activity (the automatic stabilisers); the expenditure and revenue cost of fiscal support and stimulus actions by federal and state governments; and the direct cost of managing the pandemic in Australia (eg the cost of testing for Covid-19; the cost of quarantine arrangements; and the cost of vaccines).

How much of this cost was avoidable will be debated for years to come, as was the case after the fiscal stimulus and debt blow-out associated with the GFC. Clearly, a substantial part of it was not avoidable,

[i] Parliamentary Budget Office, 2020-21 Medium-term Fiscal Projections, Report No. 04/2020, Commonwealth of Australia, December 2020.

but there is plenty of scope for argument about the wisdom of some of the stimulus and support spending. As Tony Makin has written, "There was clearly an over-reaction on the fiscal side", stemming from "an ill-advised 'whatever it takes' mindset".[ii] Discretionary stimulus spending is particularly questionable at the state level as fiscal stimulus has not traditionally been considered a state government responsibility.

Regarding the relative roles of the federal and state governments in the fiscal response to the pandemic, one criticism that has often been levelled at the states is that they have been quick to order the closure of businesses and to impose other restrictions because they knew the federal government would bear the fiscal cost through JobKeeper and other policies. However, the data presented in this report show that while the Commonwealth is bearing the lion's share of the cost the states are also bearing a large cost relative to their size, and that much of this cost is discretionary. While it may well be true that the states are happy to take a free ride at the Commonwealth's expense, they have also demonstrated through their own policy choices that fiscal discipline is a low priority for them.

The most popular view among economists is that fiscal largesse is necessary to fuel a strong recovery and that the resulting massive deficits and debts are affordable because interest rates are extremely low. Budget projections of the Commonwealth and the states show public debt interest expense at historically low levels and remaining very low, despite the upsurge in debt, on the assumption that interest rates remain very low. However, on a longer term view of the risks, this relaxed attitude to debt servicing costs is difficult to justify. Interest rates are unlikely to remain at such low levels beyond the short-term and as existing public debt is refinanced interest expense will rise sharply and crowd out other government expenditures. Also, as Makin observes, refinancing "soaks up funds that could be used for more productive purposes, further limiting the economic welfare of future generations".

The prospects for a reversal of the debt build-up rest on many variables. What can be said with the greatest confidence is that there will be no reversal – to the contrary, a continued build-up – for the next few years. The history of enlarged deficits and debt is that once they start they develop an unstoppable momentum for a period measured in years. This is confirmed by the experience after the early 1990s recession and the GFC episode. The recent Commonwealth and state budget projections of continuing large (albeit declining) deficits and additions to the stock of debt up to the end of the current forward estimates period (June 2024) appear entirely realistic, even though they are likely to be proven wrong in their exact magnitude. Although some economists think treasury estimates are too pessimistic at this point, they should allow for the wide range of uncertainty surrounding any estimates in present circumstances, and for the fact that the estimates are based on the usual technical assumption of 'no policy change', which includes no new spending measures. In reality, there will be new spending with or without changes of government.

In the longer term, the range of uncertainty widens. Some economists take the relaxed view that economic growth will take care of the debt burden, as it did after the Second World War when Commonwealth gross debt on issue shrank from over 100% of GDP to 10% in 20 years. These economists rest their case on the arithmetic truism that the ratio of debt to GDP will decline as long as the rate of economic growth exceeds the rate of interest on the debt, which historically it usually has. However, while this is true of legacy debt, it does not take into account the additions to debt from financing of continuing deficits. In that connection, both Treasury and PBO projections to 2030/31 point to persistent sizeable Commonwealth budget deficits, still running at 1 to 2% of GDP at the turn of the decade. The impact of the pandemic has created not just a short-term deficit but a structural one – and this is likely to be true of the states also, although there are no long-term projections to quantify the impact.

Moreover, history never repeats itself exactly. The 20 years or so after 1945 were in many respects the golden years of growth, and are unlikely to be equalled in the very different circumstances of the next 20 years. The shrinkage of the debt burden was also made easier by the fiscal discipline that characterised the era and by financial repression – the process by which governments got away with paying debt-holders low or negative real interest. That is unlikely to be repeated in the more sophisticated and less regulated financial markets of today.

For all these reasons, the official Treasury and PBO projections showing the debt burden easing only very gradually after a peak in 2023-24 appear more realistic than the optimistic view that the post-war experience of a rapid decline in the debt burden will be repeated. Fiscal policy will be grappling with the debt burden for many years to come, and the first task will be to close the structural deficit that has opened up. This should concentrate the minds of our economic policy-makers as soon as the pandemic passes and a semblance of normality resumes.

[ii] Tony Makin, 'Wrong lessons in Covid response', The Australian, 31 December 2020, p 9.

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Robert Carling is a Senior Fellow at the Centre for Independent Studies, an independent public policy research and educational institute based in Sydney. He undertakes research into a wide range of public finance issues and regularly comments in the media on taxation and other budget issues. His most recent publication under the CIS banner was 'The Economic Challenge of Covid-19'. Before joining the CIS, he was a senior official with the New South Wales Treasury, and before that, with the Commonwealth Treasury.

Related Works

Robert Carling, *State Finances after the Pandemic* (CIS Policy Paper 29, May 2020)

Robert Carling, *The Economic Challenge of Covid-19* (CIS Policy Paper 32, July 2020)

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