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A SEA OF RED: TRACKING AUSTRALIA'S DEBT ICEBERG

Robert Carling

CIS Pandemic to Prosperity

THE CENTRE FOR INDEPENDENT STUDIES

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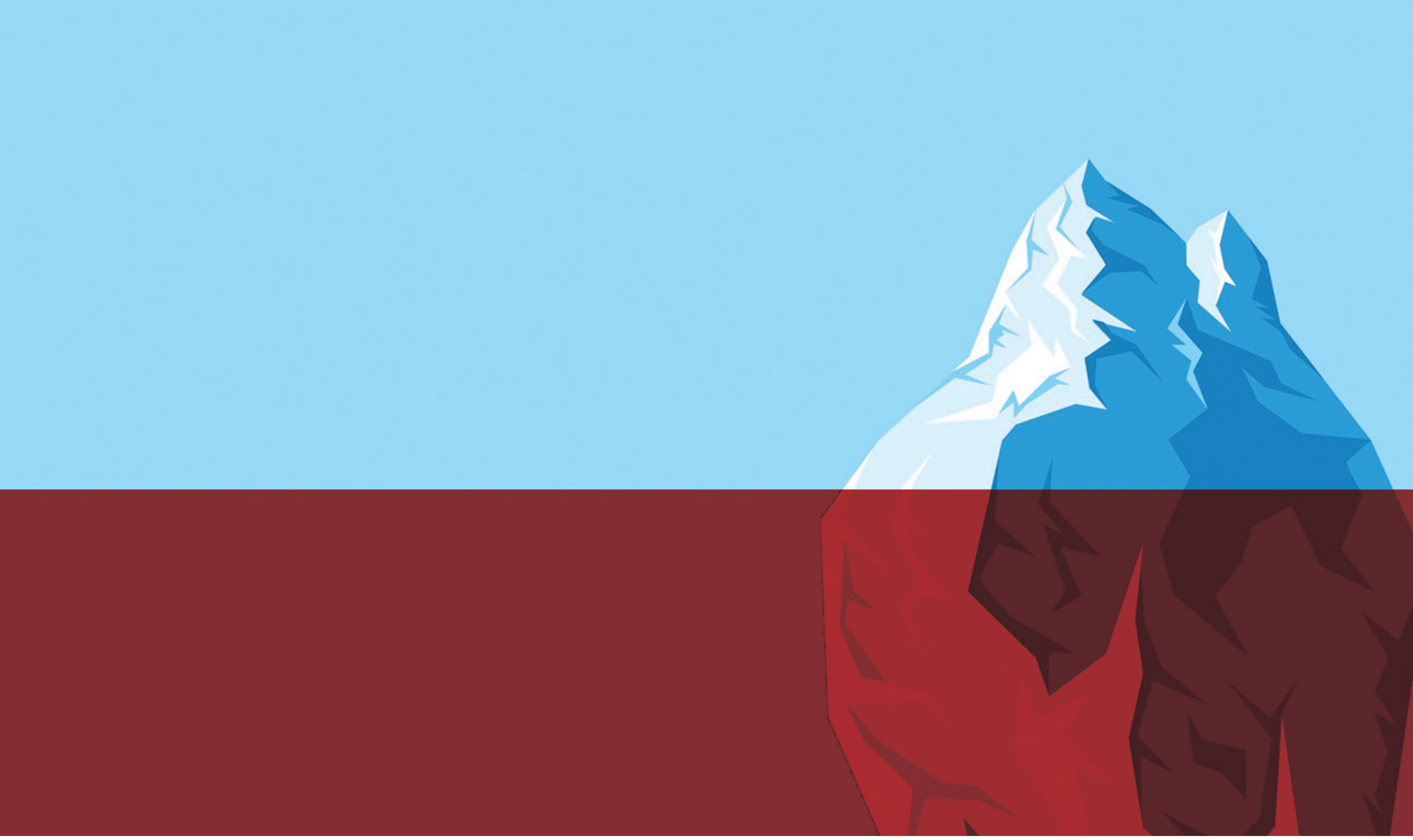


Introduction

The backdrop to the forthcoming federal and state budgets for 2022/23 is that Australia's public debt has increased sharply during the pandemic since 2019 — and is projected to increase further. The dimensions of this debt burden should be an important consideration in shaping the budgets to come.

For example, according to the most often cited measure of debt, general government sector net debt of the federal and state/territory governments is expected to be a little over $900 billion at the end of 2021/22, an increase of $480 billion on three years earlier. A further increase of $380 billion is expected in the next three years.

When related to GDP, this represents an increase from 22% in 2019 to 41% in 2022 and 53% in 2025.

This increase in borrowings has occurred primarily to finance operating deficits, rather than public investments that will generate future returns.

There is some comfort in the fact that the increase in debt is not as large as was estimated 12 or 18 months ago, in the depths of uncertainty about the pandemic. Since then, budget deficits have been revised down and GDP has been revised up. At the same time, however, the outlook for interest rates has shifted towards higher rates in the near term, which will lift the cost of servicing debt.

Taking all this into account, the increase in debt raises economic policy issues of major concern. It is reducing fiscal flexibility and the capacity of governments to respond effectively to future crises. It may also act as a drag on economic growth in the longer term.

There is no prospect of debt being paid down as it was in the decade up to 2007. This would require budget surpluses and/or large privatisations of public enterprises — neither of which is likely. To the contrary, the outlook is for continuing structural budget deficits and there are fewer opportunities for privatisations, with none of substantial scale on governments' agendas.

The best that can be expected is that the debt burden will be gradually eroded relative to GDP as the economy grows. However, this will require interest rates on government bonds to remain below the economic growth rate. It will also require fiscal discipline that places budget deficits on a path to elimination over the next several years.

This is the key lesson for the coming round of federal and state/territory budgets, and in particular a warning that expenditure restraint needs to be exercised.

This report provides an update of measures of Australia's public debt based on mid-year budget reviews released by the Commonwealth, state and territory governments in late 2021.

The national debt outlook

The national public debt comprises that of the federal government and the states and territories. (Although local government is a part of the public sector, its overall debt is stable and relatively immaterial.) Outcome data are available up to 2020/21, revised budget estimates for 2021/22, and forward estimates to 2024/25.

The picture is one of rapid growth in the public debt. While the federal debt continues to dominate, state and territory debt has also risen rapidly. This is shown in the following series of graphs.

As shown in Figure 1, general government net debt — the measure most often used to gauge the debt burden — is estimated to reach 53% of GDP in 2024/25, up from 22% in 2018/19 before the impact of the pandemic began to be felt. This increase over six years is larger than that over the previous 11 years. Taking a longer term view, net debt was negative in 2006/07 but increased sharply with the impact of the global financial crisis and the extended period of federal budget deficits that followed.
Thus, most of the increase in net debt up to 2018/19 was at the federal level, but since then both the Commonwealth and the states have recorded strong growth in debt. The state/territory share will increase from only 14% in 2018/19 to 30% in 2024/25. As discussed below, the growth of state debt is being driven both by the pandemic impacts and the large program of infrastructure spending in some states.

In nominal dollar terms as shown in Figure 2, net debt is increasing from $426 billion in 2018/19 to $906 billion this year and $1,288 billion in 2024/25, making for a total increase of $863 billion in the six years after 2018/19. Federal net debt has increased by $300 billion since 2018/19 to this year, and is projected to increase by another $240 billion to $915 billion by 2024/25.

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

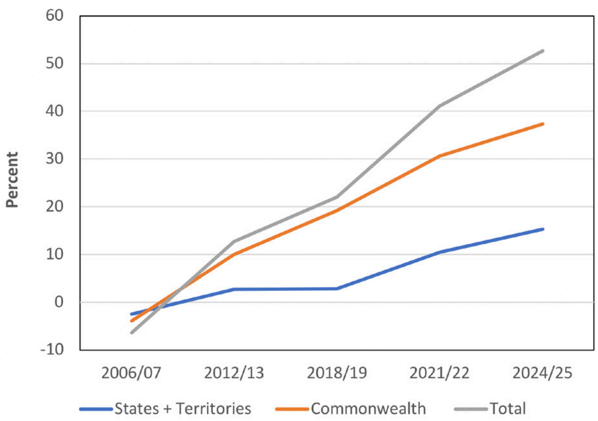


Figure 2: General Government Net Debt ($ billion)

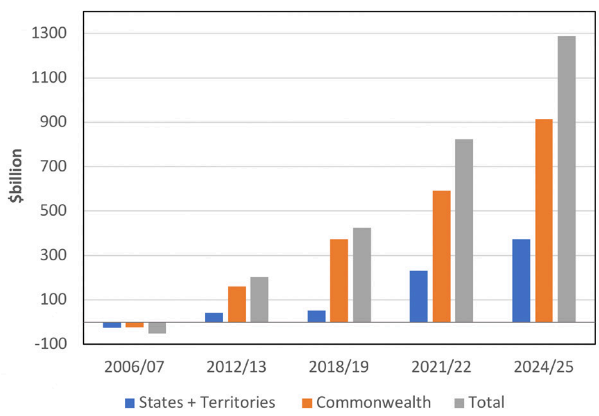


Figure 3: General Government Gross Debt (as % of GDP)

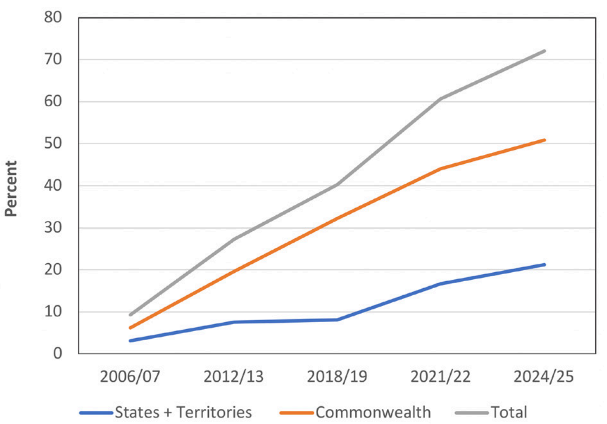
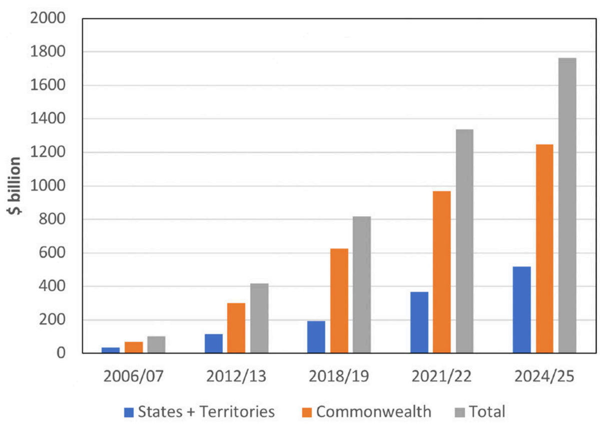


Figure 4: General Government Gross Debt ($ billion)



Over the same periods, state/territory net debt increases by $180 billion and $140 billion respectively to $373 billion in 2024/25.

Excluding financial assets, general government debt in gross terms, as shown in Figure 3, has the same time profile as net debt but at higher levels. Gross debt was less than 10% of GDP in 2006/07, rose to 40% by 2018/19, and is set to rise further to more than 70% by 2024/25. Federal gross debt alone is expected to exceed 50% of GDP in 2024/25. To put this into historical perspective, until 2016/17 federal debt on issue had not exceeded even 27% of GDP in 50 years of records back to 1970/71.

In nominal dollar terms, as shown in Figure 4, gross debt has risen from $100 billion in 2006/07 to $817 billion in 2018/19. It is well over $1 trillion this year and is set to rise further to $1.8 trillion by 2024/25. Commonwealth gross debt alone will exceed $1 trillion by 2022/23.

So far in this update the figures refer to the general government sector, which comprises core government departments and authorities dependent on budget funding. A broader concept of the public sector is the so-called non-financial public sector, which also takes in government trading enterprises which are largely financially self-sufficient but for which governments are ultimately responsible.

As shown in Figure 5, this measure of gross debt is several percentage points of GDP higher than the comparable general government measure. The difference is concentrated at the state level, as this is where most indebted government trading enterprises exist. On this measure, gross debt increased from 46% of GDP in 2018/19 to 66% in 2022 and will rise further to 77% in 2024/25.

The national debt outlook has improved slightly over the past year. In early 2021 total non-financial public sector gross debt was expected to exceed 80% of GDP by 2023/24 and general government sector net debt to reach 60% of GDP. The latest estimates are several percentage points lower. This is because budget deficits have been revised down in some years and projections of GDP have been revised up.

Figure 5: Non-financial Public Sector Gross Debt (as % of GDP)

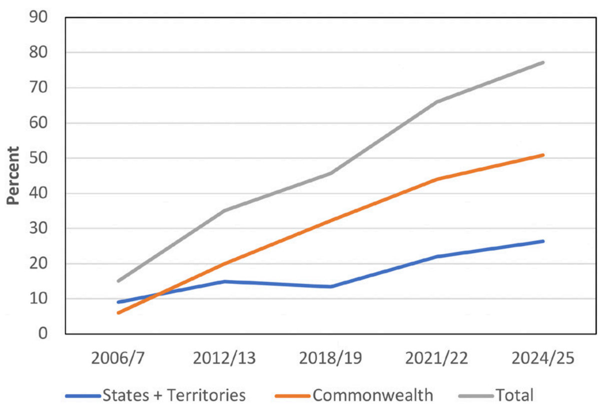
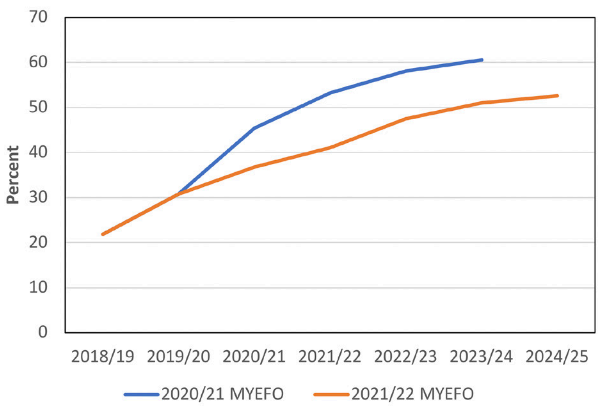


Figure 6: Revisions to Projected Total General Government Net Debt (as % of GDP)



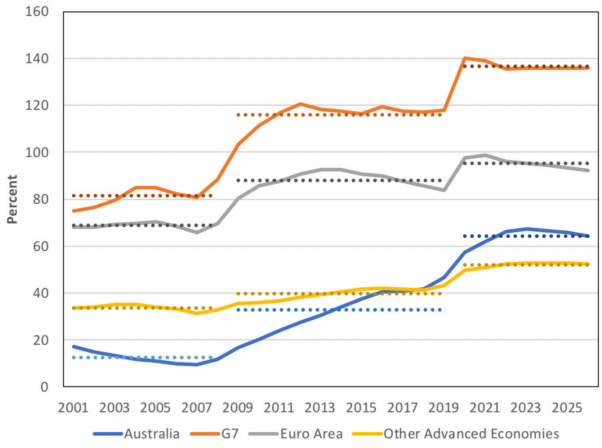
International comparisons

As illustrated in Figure 7, which is based on International Monetary Fund data, public debt has also increased rapidly in other advanced countries. The IMF's international comparisons focus on general government gross debt and the data for Australia are not identical to those presented above because the IMF looks at calendar years and makes its own forecasts and at different times from Australian governments.

There are two key points about these international comparisons from Australia's perspective. First, while it is often said that our public debt is well below that of other advanced economies, that is mainly because of the very high debt levels of a few large countries, namely the US, Japan, the UK, France and Italy. This is shown in the line labelled 'G7' in Figure 7, the G7 comprising those five countries plus Germany and Canada. Compared with other advanced countries, the gap with Australia is narrower.

Second, the gap has been narrowing as Australia's debt has been increasing faster than that of many other advanced countries. In fact, Australia has recently overtaken the 'other advanced' group. The reasons for this are complex, but include Australia's exceptionally large fiscal support and stimulus measures during the pandemic, and the large deficits of the states, which are partly due to large infrastructure building programs.

Figure 7: International Comparisons of General Government Gross Debt (as % of GDP)



Dotted lines are averages of 2000-08, 2009-19 and 2020-26 respectively.

State comparisons

Figures 8 – 10 focus on the states and territories. They illustrate 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.

While on all measures net debt was low in 2009-10 and remained moderate up to 2018/19, it has increased sharply since then and is projected to increase further up to 2024/25. By then, net debt will far exceed 100% of a year's operating revenue. (In fact, this position will be reached in the most heavily indebted states and territories in 2021/22.) This represents a substantial weakening of state and territory fiscal positions and it is not surprising that one credit rating agency has stripped both New South Wales and Victoria of their AAA credit ratings.

Figure 8: General Government Net Debt of States and Territories

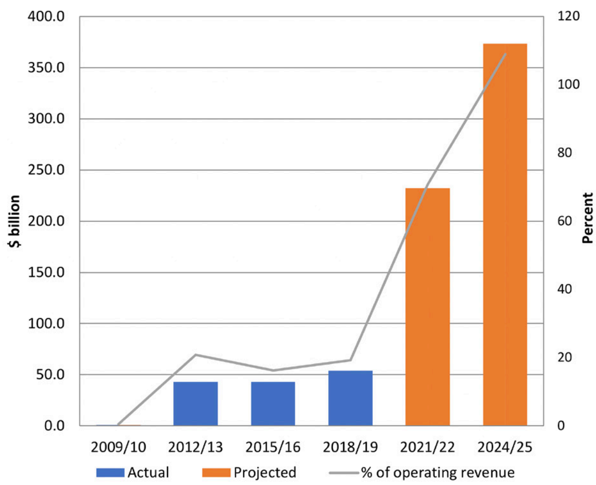


Figure 9: General Government Net Financial Liabilities of States and Territories

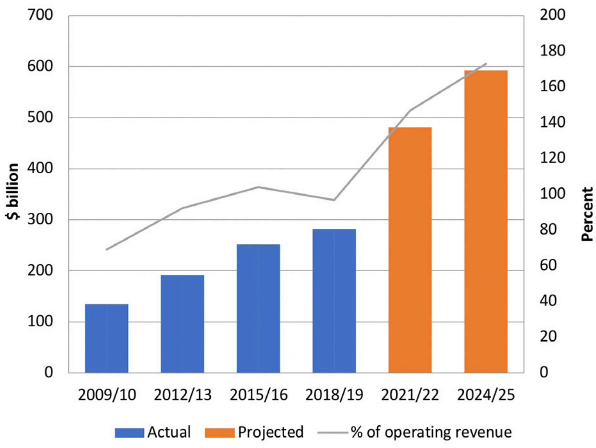
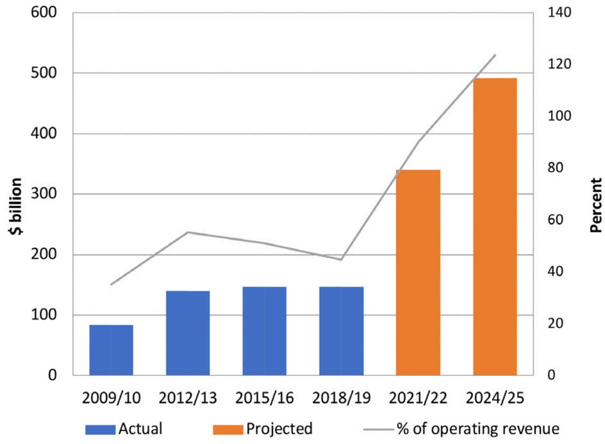


Figure 10: Non-financial Public Sector Net Debt of States and Territories



These aggregates conceal significant variation among the states, the detail of which is shown in figures 11 – 13. 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 2024/25, and the largest increase from the pre-pandemic position in 2019. This also stands if the two territories are included in the comparison. NSW is in a stronger position than Victoria but exhibits the second largest increase in debt burdens which will bring NSW more in line with the average.

Figure 11: General Government Net Debt of States (as % of operating revenue)

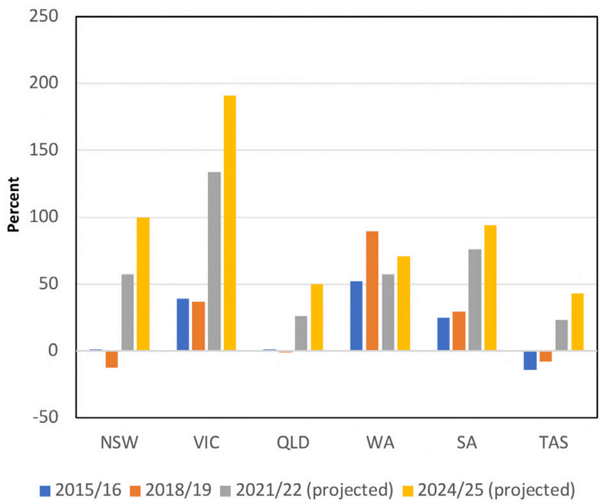


Figure 12: Non-financial Public Sector Net Debt of States (as % of operating revenue)

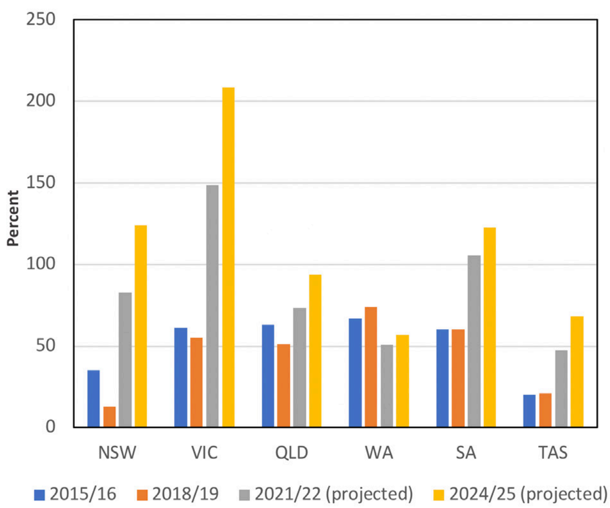
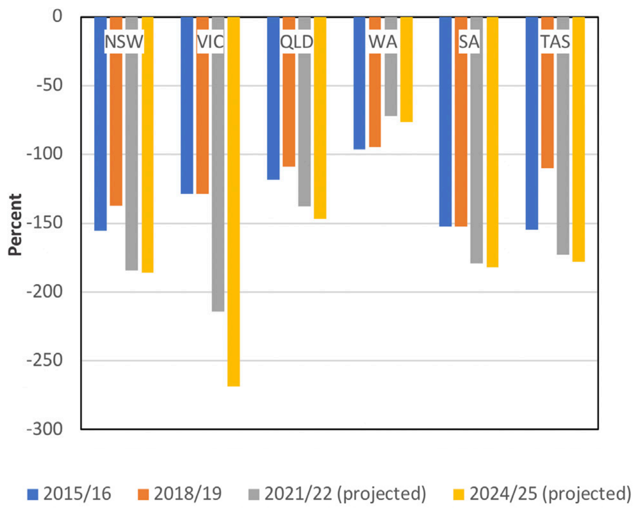


Figure 13: Non-financial Public Sector Net Financial Worth of States(as % of operating revenue)



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 $525 billion over the six years beginning with 2019/20. The broader fiscal balance measure also shown in Figure 14, which also includes net capital expenditure, reveals a similar six-year deficit aggregate of $577 billion. 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. Thus, the increase in Commonwealth debt is being driven overwhelmingly by an operating (or 'recurrent') deficit.

Moreover, the federal operating deficit has been driven more by the rapid growth of expenditure than by revenue weakness. Figure 15 illustrates the evolution of federal budget payments estimates since 2018/19, from the pre-pandemic 2019/20 budget to subsequent budgets and mid-year budget reviews, culminating in the 2021/22 mid-year review in December 2021. The pre-pandemic outlook was for payments to remain flat as a share of GDP, but by the 2019/20 budget this profile had been revised up dramatically; although the outcome was for payments to increase less dramatically than expected.

The pandemic was not the only factor driving the increase, as programs such as the NDIS and aged care have also been rising strongly. Thus, as Figure 15 illustrates, a lasting gap of more than 2% of GDP has opened up between pre-and post-pandemic expenditure estimates, which will make deficit reduction very difficult.

In state budgets, capital expenditure looms much larger than in the federal budget. In the past, states have generally adopted the principle that net operating budgets should be in surplus, which means 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.

Historically, states have generally passed this fiscal test. While some states have occasionally dipped into a net operating deficit for limited periods, this has been exceptional. Figure 16 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. In marked contrast, the aggregate net operating result plunged to a deficit of around $20 billion in both 2019/20 and 2020/21 and is estimated to exceed $40 billion in the current financial year before shrinking, but only returning to balance in 2024/25. Western Australia is the only state reporting net operating surpluses each and every year.

In aggregate, over the five years 2019/20 to 2023/24, state and territories are estimating operating deficits totalling almost $100 billion. This is unprecedented in the recorded history of state finances. It means that 30% of the projected total increase in state general government debt over those five years will finance net operating deficits rather than infrastructure.

Figure 14: Net Operating Balance and Fiscal Balance, Commonwealth ($ billions)

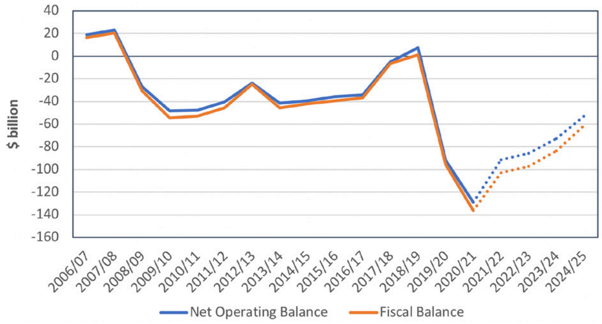


Figure 15: Commonwealth Payments (as % of GDP)

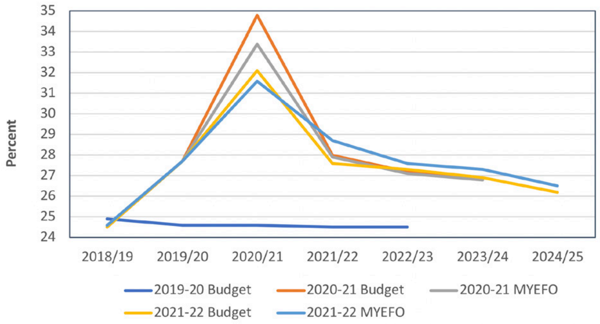


Figure 16: Net Operating Balance, States and Territories ($ billion)

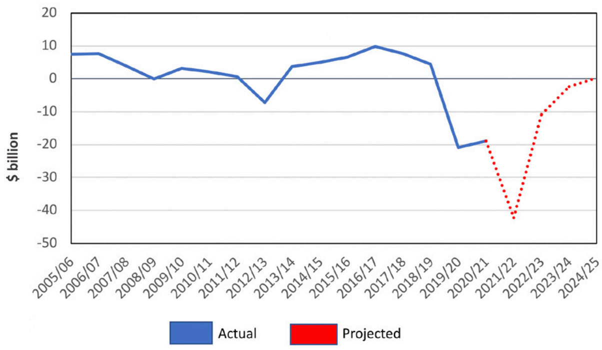


Figure 17 reveals which states have gone farthest into deficit by showing the net operating deficit as a percentage of total operating expenses in the peak deficit year, 2021/22. Victoria, NSW and the ACT are the leaders at 15—20%, but all the states and territories other than WA are also financing a significant proportion of operating expenditure out of borrowings.

Because the states and territories have large capital expenditures, their broader fiscal balance (shown in Figure 18) has normally been in deficit and has gone further into deficit in recent years than the net operating balance. Indeed, the total deficit on this measure over the five years from 2019/20 is $225 billion, compared with about $100 billion for the net operating balance. Moreover, unlike the net operating balance, the fiscal balance is expected to remain in deficit ($22 billion in 2024/25).

Figure 17: States and Territories Net Operating Deficit (as % of operating expenses, 2021/22)

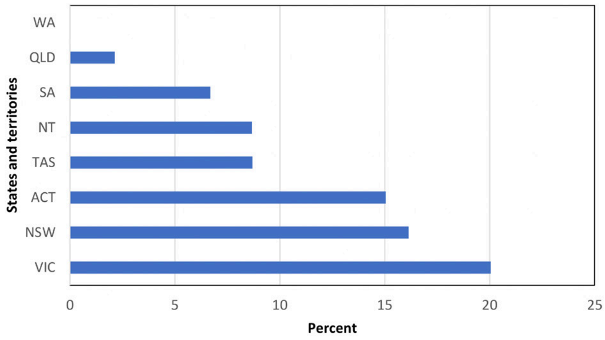
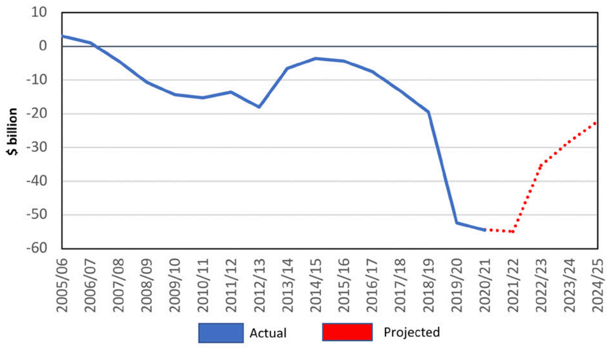


Figure 18: Fiscal Balance, States and Territories ($ billions)



Discussion of issues

The Australian exceptionalism that came with low levels of public debt has gone for the foreseeable future. The pandemic has seriously weakened Australia's public finances. 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.

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 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.

We can therefore say that looking at the Commonwealth and states in aggregate, general government net debt on current estimates will increase from 22% of GDP in 2019 to 53% in 2025. This staggering amount — some $860 billion — results mainly from the costs of the pandemic and associated policy responses:

- 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 blowout associated with the GFC. Clearly, a substantial part of it was not avoidable, but there is plenty of scope for argument about the wisdom of some of the stimulus and support spending. 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 was necessary to fuel a strong recovery and that the resulting massive deficits and debts are affordable because interest rates are extremely low. Federal and state budget projections 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. The outlook for interest rates has recently shifted towards higher interest rates in the near term. As existing public debt is refinanced interest expense will rise sharply and crowd out other government expenditures.

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 federal 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 2025) 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 federal 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 Parliamentary Budget Office projections to 2030/31 point to persistent sizeable federal budget deficits, still running at almost 2% of GDP at the turn of the decade. The impact of the pandemic has combined with growth in other expenditure programs, such as the NDIS and aged care, to create not just a short-term deficit but a structural one — and this is likely to be true of the states also.

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 in the coming budgets for 2022/23 and beyond.

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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. 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, *The Looming Iceberg: Australia's post-pandemic debt risk*, Policy Paper 35, January 2021

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