CIS POLICY FORUM 25

TARGET30: REDUCING THE BURDEN FOR FUTURE GENERATIONS

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THE CENTRE FOR INDEPENDENT STUDIES

TARGET30:
Reducing the Burden for Future Generations

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TARGET30 Paper

T30.03 Jeremy Sammut, *Saving Medicare But NOT As We Know It* (2013).

T30.02 Andrew Baker, *Tax Welfare Churn and the Australian Welfare State* (2013).

T30.01 Simon Cowan, *Towards Smaller Government and Future Prosperity* (2013).

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Introduction

Greg Lindsay

Good evening and welcome to this important event on the CIS calendar, the launch of our TARGET30 program.

I'd like to thank the Macquarie Group for hosting us here in the centre of the city. I'd also like to thank David Murray and Maurice Newman for participating in tonight's proceedings.

In many ways, tonight's event for me brings a strong sense of *deja vu*. The Centre for Independent Studies (CIS) started in the wake of the Whitlam years, which saw the first big growth spurt in government in recent history. From 24% of GDP in the beginning of the Whitlam era, the size of government has skyrocketed by 50% to nearly 36% of GDP. Maybe I have been wasting my time all these years, but I don't think so. The tidal flow of government is overwhelming. Yes, there have been positive reforms and we are a much richer, and in some ways, freer nation—though there are worrying signs on that front too. The CIS certainly had something to do with that successful reform period. However there seems to be a fault in the way modern democracies function with the political market being rigged to one side—the supply side. Things could have been far worse in Australia as the current European situation shows. I am sure the CIS has played a role in fending off that fate as well, but the signs in Australia are not good right now, particularly with this lengthy election campaign (which is not a campaign) threatening to splash cash in all directions.

TARGET30 is about bringing solutions to these problems based on the skills and ideas we have developed over the years. It won't be easy. As P.J. O'Rourke, our friend and past John Bonython lecturer, said, 'The mystery about government is not how it works but how to make it stop.' That's a mystery we intend to solve and for which we need your help.

Tonight we have three speakers:

David Murray was chairman of the Australian Government Future Fund Board of Guardians, serving between 2006 and 2012, and chair of the International Forum of Sovereign Wealth Funds. He was the Chief Executive Officer of the Commonwealth Bank of Australia between 1992 and 2005 and presided over a great period of growth there.

Maurice Newman until March 2012 was the chairman of the ABC as well as former chair of the board of the Australian Stock Exchange. He was chancellor of Macquarie University until 2008. Maurice was also on the founding board of the CIS and our second chairman, serving for nine years after Neville Kennard.

Simon Cowan is the lead author of the TARGET30 foundation document. He is a research fellow in the economics program working on government industry policy and regulation. He has practised corporate law at a top-tier law firm in Sydney and London and worked with the NSW government's industry division.

And before I finish, another serving of PJ.

> Feeling good about government is like looking on the bright side of any catastrophe. When you quit looking on the bright side, the catastrophe is still there.

TARGET30: Getting Australia on the Right Track

Simon Cowan

We have come through a period of extraordinary economic growth in this country, with sustained increases in GDP stretching back for decades.

Yet in spite of these unique circumstances, the size of government in Australia has kept growing. Spending across all three levels of government has increased at an average rate of more than 4% a year since 1972. Today, the government rakes in more than a third of everything this country produces.

Governments have been spending in bad times, trying to buy their way out of recessions, and governments have been spending in good times 'to spread the benefits of the boom.' Across the world, decades of misguided policies have created bloated governments and societies in crisis.

But TARGET30 is not about what has been done wrongly in the past. TARGET30 is about the future.

In the future, Australia will face substantial challenges from an ageing population, rising health care costs, and slower economic growth. These conditions mean that government could exceed 50% of GDP by 2050, burdening future generations with higher taxes, higher debts, and a further breakdown of society.

The Centre for Independent Studies (CIS) has launched the TARGET30 campaign to try and break these trends and prepare Australia to meet these challenges. TARGET30 promotes the benefits of smaller government and aims to reduce government spending to less than 30% of GDP in the next 10 years.

The initial research in TARGET30 will focus on health, welfare and education because, taken together, these areas make up more than 60% of government budgets. TARGET30 will focus on ways to deliver these essential services efficiently and effectively, while reducing wasteful spending.

Currently, government spends approximately $60 billion a year more than it should. Without TARGET30, governments could be wasting $150 billion a year by 2021. We cannot and should not meekly accept that future tax rises are inevitable because of claims that governments don't have enough money to meet their basic obligations.

Government spends about half a trillion dollars a year, and many spending programs are either unnecessary or poorly designed. The failures of governments in areas like defence and infrastructure should be put down to incompetence, not underfunding.

However, the forces of big government marshalled against us are enormous. Government spending has created a legion of vested interests with incentives to vote for even greater largesse. The CIS estimated that nearly half of all voters in the 2010 election were receiving the majority, if not all, of their income from the government.

These difficulties in reducing spending are why TARGET30 proposes a practical and achievable target. It is a target for reducing government spending that can be met by holding spending constant in per capita terms. It is a compromise between the economic ideal and what is realistic.

Subsequent reports in the TARGET30 series will deal in more detail with specific suggestions to cut spending, but there are some practical steps we can take now to get us on the right track. A good starting point for the next government is to audit all existing government departments and programs to determine what programs are really necessary, and what programs are effective in meeting people's needs.

Obvious areas of inefficiency and waste should be cut immediately. These include the billions provided in corporate welfare to the foreign car makers and others and the massive duplication of functions at the state and Commonwealth level.

To meet the challenges of an ageing population, we must spur improvements in public sector efficiency and productivity, especially in aged care and hospitals.

We must encourage competition and let consumers make meaningful choices through user charges and be explicit about the

true cost of government subsidies in areas such as public transport and pharmaceutical benefits.

We must improve public sector workforce productivity by appropriately rewarding good performers and making it easier to remove poor workers.

We can create a competitive advantage for our economy by cutting red tape and government wheel-spinning. Reducing welfare churn alone would go a long way to meeting the TARGET30 goals.

It is clear that TARGET30 is not an austerity campaign, it doesn't propose abolishing welfare, and it doesn't punish the poor. It is about asking Australians to stop demanding more and more services from the government that they would like but don't want to pay for and start focusing on the things they really need.

‘Go Back, Wrong Way’

David Murray, AO

Please accept my sincere thanks for the opportunity to support this timely and critical piece of commentary by the CIS.

I want you to recall the large red signs at the wrong entrance to motorways: ‘GO BACK, WRONG WAY.’ The signs also aptly describe the current state of the Australian economy and its public finances. Having been through the early stages of the global financial crisis and watched the policy errors of those that created it, it’s reasonable to say Australia has the chance of a lifetime to redirect its policy before it is too late.

Turning things around will, however, require a degree of transparency and honest debate that we do not see today. In time, this will call for a clearer understanding of the Australian culture and why it is able to drift in what Professor Ross Garnaut has called the ‘great complacency’—a culture in which the Australian people do not hold their electoral representatives to account and the representatives are not prepared to be held accountable.

The good news is that things can be turned around if we have a shared understanding of what has happened in the world, the truth about the Australian economy and its finances, and lastly, the general shape of the solution.

Let me start with what has happened in the world and where we are now in the unfolding of the global financial crisis. I say unfolding because it is by no means over.

Make no mistake, the crisis was caused by loose fiscal and monetary policy over an extended period in the world’s two largest economies, the United States and the European Union. Excessive financial leverage and asset price distortions created a crisis of proportions not seen since the 1930s—requiring an immensely long process of painful resolution, a process that has hardly begun.

More than five years on, both Europe and the United States in the post-crisis period have higher government debt than in 2006—US$17 trillion in the United States alone. Both economies are in political deadlock over the degree of fiscal austerity necessary to work towards a long-term solution. In fact, the process of offering debt-funded entitlements to attract votes does not appear to have been challenged very seriously.

The consequence of political inaction has been to leave the response to central banks to stimulate growth with aggressive and unconventional monetary policy. This in turn has led to a major currency war recently joined by Japan. It is hard to predict the outcome of a currency race to the bottom, but it is about stimulating short-term growth while avoiding the hard fiscal decisions needed for long-term, sustainable growth.

So what is the truth about Australia's position? I learned in relation to competition and business strategy that a firm should never get into a position where it is neither able to attack nor defend itself. This is where Australia is headed.

Australia's cost structure is too high, largely driven by high wages, and productivity improvement is weak. Although unemployment appears low, wages are growing at close to 4% per annum but total hours worked in the economy are falling. Overall productivity is unimpressive. Since labour generally accounts for most business costs, the outlook for employment is weakening. The Europeanesque process of continually increasing regulation reduces productivity by adding steps to work process rather than taking steps out.

Both the budget and current account are in structural deficit, meaning that the deficits cannot be removed without a structural change to the economy, and the serious policy changes needed to effect it.

In the case of the budget, Commonwealth outlays, which are most challenging to address, namely, welfare, education and health, increased from 20% of total outlays in 1971 to 58% in 2011. Welfare spending costs $132 billion. Without some tough decisions, these expenditures will remain a rising and fixed cost detached from the fortunes of the economy, which is subject to changes in commodity

prices, world growth patterns, and other exogenous factors. Hence, we already have an operating leverage problem in the budget. Generally, this puts a lower limit on debt funding.

So, after 21 years of continual growth and the best terms of trade in 150 years, Australia has structural budget and current account deficits. Dependency on foreign capital is the main driver of the current account deficit, but the trade balance has rarely been positive notwithstanding the terms of trade boom. In short, Australia must refinance its net payments of dividends and interests to foreigners each year. Without offsetting capital inflow, this amounts to some $40 billion per annum and results from Australia's high level of net foreign liabilities—some 57% of GDP. Capital inflow depends heavily on commodity prices and mining investment, both of which have peaked against the backdrop of high and uncompetitive cost structures.

The combination of structural deficits, high operating leverage, and high net foreign liabilities means Australia cannot match the level of government debt of some other nations. The United Kingdom and the United States have very much higher private sector foreign assets, notwithstanding that their governments have high foreign debt. Australia has high foreign liabilities that comprise both public and private obligations.

Going into the crisis, Australia's critical asset was the absence of Commonwealth debt and its AAA rating. But gross debt is now approaching $300 billion or about 18% of GDP (the net debt of 9% of GDP is not the relevant number because bond holders do not have a right of set-off against other assets).

In the event that bondholders want to redeem their bonds, they know a government can pledge or run down its assets. Hence, a structural deficit raises their risk.

The majority of this debt, about 80%, is held by foreigners, which means Australia's spending decisions, including political promises, are increasingly in the hands of foreign debt holders and the ratings agencies.

Yet the AAA rating is looking increasingly vulnerable and any downgrade would flow on to the states, the banks and corporations

generally—putting further pressure on the financing of the current account deficit and the budget through rising interest rates.

What is not discussed is the vulnerability of very high foreign liabilities and the weakness in the rating—namely, the relationship between external debt and current account receipts. This is how the rating agencies look at it. Australia falls well outside the scores of the median of AAA-rated countries.

For example, the ratings agencies' measure of external debt as a percentage of current account receipts is about 100% for the median AAA-rated country but over 200% for Australia and the median G7 country. Ultimately, with a structural current account deficit, the Australian dollar will not be a classical haven currency.

With recent confirmation that the federal budget will remain in deficit (now a negative for the AAA rating), suggestions for foreign buying of Commonwealth Government Securities (CGS) have gone down, and with a marked slowdown in mining investment it is time to reassess policy.

In thinking about the solution, it is helpful to reflect on government spending trends. In general, governments have increased spending on 'nice' things but decreased spending on 'valuable' things. Put another way, they have increased consumption-related spending and decreased investment-related spending. Why is this important? I believe we operate in one system, a system that has people, government, and a private and a public sector. Making this system work in harmony is what matters.

The solution lies in both reducing overall government spending but increasing the proportion of investment related spending.

As TARGET30 will show, consumption-related expenditure eventually becomes a drag on the economy. But the government is better placed to invest than the private sector in some areas—particularly in infrastructure where there are positive spillover effects, and externalities arising from the public sector's capacity to pool risks.

To achieve the overall outcome and the right balance requires government to confront productivity improvement in the economy generally and in its own activities. This has been done elsewhere

by facing up to far more efficient delivery of health, education and other services in ways we have not been willing to accept.

In respect to infrastructure, there must be publicly transparent processes for project ranking and selection based on standards for cost-benefit analysis and publication of results. This would not be unique.

This approach, together with the trading of wage rises for tangible productivity improvement and reduction of the regulatory burden, would turn things around more quickly than most appreciate.

It does however call for a dose of reality. Recent suggestions to use our AAA rating and the historically low cost of debt to finance large investments in infrastructure would, without offsetting adjustments, be a 'cargo cult' experiment that could leave us even more exposed.

The general wake-up call that we cannot borrow more needs to be part of a cultural shift in which we reject spin, stop copying Europe, fight for transparency, hold our politicians accountable, and elect only those who want to be accountable. We must discuss the risks to our democracy and rule of law that come from complacency.

We are lucky because we can turn this around. Remember that sign on the motorway—it calls for an early and decisive posturing. I have no doubt the CIS' TARGET30 will make an extraordinarily valuable contribution to fixing the state of our finances.

The Consequences of Too Much Government

Maurice Newman

Congratulations to the CIS for beginning the TARGET30 program—it is indeed a worthwhile program. I have to say though that as a former chair of the CIS, I never thought I would ever need to support a campaign to reduce government spending from 35% of GDP to under 30% in 10 years. It's extraordinary. But during my time as chair of the CIS, which was from the mid-1980s to the early 1990s, just 20 years ago, government spending was as low as 22.8% of GDP—and I thought that was too high. But here we are 20 years on, and I don't think it is a stretch to say government spending will reach 50% of GDP by 2050. After all, we've gone from 22.8% to 35% in just 20 years.

But that was then and this is now. Unless we take a stand to arrest this steady rise in government spending, Australia will become yet another moribund socialist-democratic state like Great Britain with a 47.3% of government size to GDP (France has 52.8%, Belgium 50%, and Italy 48.8%). It's no accident that in high growth countries such as China, which is a communist country, the size of government to GDP is just 20.8% (and 17% in Singapore). They do much better with smaller government because big government is inefficient.

What we know is that explicit taxation in most developed economies is only part of what citizens are levied. Borrowings make up the rest. So it is what governments spend, not what they tax, that should be the focus of economists and voters. It is a sign of the times that since the recent UK ratings downgrade, there are now only 11 AAA rated economies in the world, and three of them are on negative watch. That's a pointer to the financial position of the world we live in and a lesson about where undisciplined 'tax, borrow and spend' policies are leading us.

In Australia, we have gone from a zero net debt position in 2007 to more than $150 billion in 2012. That's not bad going in five years.

As David said, the gross debt is obviously even higher. While it is true that 10% debt to GDP is not high by today's global standards, it is still an amount that has to be repaid or inflated away. Ultimately, if the rising debt continues to grow unchecked, it will call into question the capacity of today's taxpayers to discharge a debt that was largely incurred for them. As government debt grows as a proportion of GDP, and as populations age, the more likely it is that future generations will have to meet those obligations. Future generations will indeed be entitled to look back at their parents and grandparents and say those people were uncaring and selfish—and so they were.

Clearly, what we are seeing in Europe is a consequence of too much government. Rather than invoke the wrath of voters by taxing too much, legislators decided to go into debt—and instead of repaying the debt, they continued to borrow and ended in a debt trap where lenders are no longer prepared to extend credit. That of course slowed growth significantly and resulted in high levels of unemployment, which has disadvantaged the young and most vulnerable. The advocates of bigger government should ponder just how these policies are caring or compassionate, because the most vulnerable people are suffering the most.

In Australia, as in the rest of the developed world, there is this myth that we can all live better at the expense of everybody else. Politicians encourage this myth and bribe voters with free goods and services. This is an unsustainable cargo cult mentality, yet it is ingrained and poses difficulties for those who are fiscally conservative and must deal with the opponents. We have seen this already in the outcry over the partial withdrawal of the Baby Bonus. There is going to be substantial opposition when these benefits are cut or withdrawn. And while the government will claim that the $70 billion spending spree was a necessary stimulus to counter the global financial crisis, a more sober assessment will show that billions of dollars were spent simply on pet ideological projects for which there is now little to show. That misallocation of capital is very costly because to the extent that the recurrent spending consumes productive capital, it also limits productivity and future growth.

The challenge for the world is how to grow the economy when government is such a high proportion of GDP and when debt is so high. It's clear from the studies of Carmen Reinhart and Kenneth Rogoff *This Time Is Different: Eight Centuries of Fiscal Follies*, and a number of other studies. These are good economists saying when government reaches about 90% of GDP, or the debt burden approaches 90%, median growth is reduced by at least 1%. Australia is far from that, and I'm not suggesting Australia is anywhere near the United States. US debt to GDP is now 106%, and approaching the danger zone where lenders start demanding a premium. While the US Federal Reserve has successfully kicked the can down the road, it should be remembered that the tepid recovery of the United States is now in its fifth year. So with the American economy teetering on the brink of another recession, with 50% of the world's economies in recession, and with China reverting to the mean, it's not unreasonable to say that Australia's terms of trade are unlikely to reach their recent heights and that Australia's own growth position is going to be under pressure.

That said, the 10 tips to TARGET30 are an excellent list of broad strategies to curb the growth of government and deliver services more efficiently. However, none of this can be accomplished unless expectations are aligned with reality and sustainability. There is no doubt the TARGET30 10 tips should be supported, but whether we end up with government at 30% or 20%, I think we will still be saying, 'Thank God we don't get all the government we pay for.'

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TARGET30:
REDUCING THE BURDEN FOR FUTURE GENERATIONS

TARGET30 is a campaign promoting smaller government and cutting government spending to less than 30% of GDP in the next 10 years. This collection of speeches presented at the campaign's launch focuses on ensuring that the crucial services Australians need are delivered efficiently and effectively while curbing the uncontrolled growth of government spending.

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