

When fiscal responsibility is economically reckless

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Before the election, Treasurer Josh Frydenberg said:

As the global storm clouds gather it's more important than ever we stay the course on our economic plan. We are watching it, obviously, very closely but we will be delivering a budget that is in surplus.¹

Prime Minister Scott Morrison explicitly teased out the twin goals of the government: 'a plan to actually grow the Australian economy and bring us into surplus'.²

Following the election, a combination of new national data and international affairs have suggested the prospects for the Australian economy are worse than anticipated. Despite this, Frydenberg forcefully ruled out economic stimulus that would delay the return to surplus, saying "No. And I can spell that".

He elaborated:

We took to the election our budget commitments and we will faithfully implement it. In fact, my first priority is about implementing our election commitments. ...

We remain absolutely committed to the surplus.³

¹ Baird (2019) *Josh Frydenberg reaffirms 2019 budget surplus in Sydney Institute election pitch*, <https://www.afr.com/news/politics/josh-frydenberg-reaffirms-2019-budget-surplus-in-sydney-institute-election-pitch-20190122-h1aboo>

² Morrison (2019) *Radio interview with Tom Elliott, 3AW*, <https://www.pm.gov.au/media/radio-interview-tom-elliott-3aw>

³ Bourke (2019) *Josh Frydenberg says surplus more important than stimulus despite weakening economy*, <https://www.smh.com.au/politics/federal/josh-frydenberg-says-surplus-more-important-than-stimulus-despite-weakening-economy-20190614-p51xw9.html>

What is the government trying to do?

It is simply impossible to use fiscal policy to simultaneously improve the budget bottom line and boost a struggling economy. The Treasurer needs to be clear about what his priority is, in both the short term and the long term.

GDP growth is at its lowest level since the Global Financial Crisis (GFC). Wage growth remains at record lows and the Reserve Bank of Australia (RBA) has not only cut the official interest rate to its lowest ever rate (1.25 per cent), the RBA Governor has suggested that the Morrison Government could use stimulatory fiscal policy to boost economic growth.⁴

When a government funds a budget surplus it is literally taking more out of the economy in taxes than it is injecting into the economy via spending and transfer payments. To be clear, the Treasurer's promise to deliver a budget surplus next year is a promise to dampen the economy even further.

The government needs to be clear whether it is prioritising promised (but arbitrary) budget surpluses over jobs and growth.

How is it trying to do it?

The Budget Papers from April 2019 forecast a budget surplus of \$7.1 billion being delivered in the 2019-20 financial year on the back of strong revenue growth and slow spending growth.⁵ However, in the 10 weeks since the budget papers were released, GDP, productivity and wage data have been weaker than Treasury forecast and, as above, the RBA has responded with record low interest rates.⁶

Growth in income tax revenue and GST is strongly linked to wages growth and employment growth. Both are flatter than Treasury was forecasting in April.

When revenue is growing more slowly than expected, the only way for a government to maintain a commitment to a particular budget outcome (such as Frydenberg's

⁴ Lowe (2019) *Today's Reduction in the Cash Rate*, <https://www.rba.gov.au/speeches/2019/sp-gov-2019-06-04.html>

⁵ Australian Government (2019) *Budget 2019–20*, "Budget overview", p. 1-1

⁶ Donaldson (2019) *Productivity "sluggish" -- but it could be worse*, <https://www.themandarin.com.au/109521-productivity-sluggish-but-it-could-be-worse/>; Janda (2019) *Reserve Bank rate cuts almost a certainty as it slashes economic outlook*, <https://www.abc.net.au/news/2019-05-10/future-interest-rate-cut-likely-rba-releases-economic-forecast/11095752>; Scutt (2019) *Australian wage growth remains sluggish and that's unlikely to change anytime soon*, <https://www.businessinsider.com.au/australia-average-wages-q1-rba-cash-rate-2019-5>

promised budget surplus of \$7.1 billion) is to cut or delay public spending. The consequence of reducing public spending is a further reduction in economic activity and, in turn, even further reductions in government revenue.

Again, the Treasurer needs to be clear about his short term priorities.

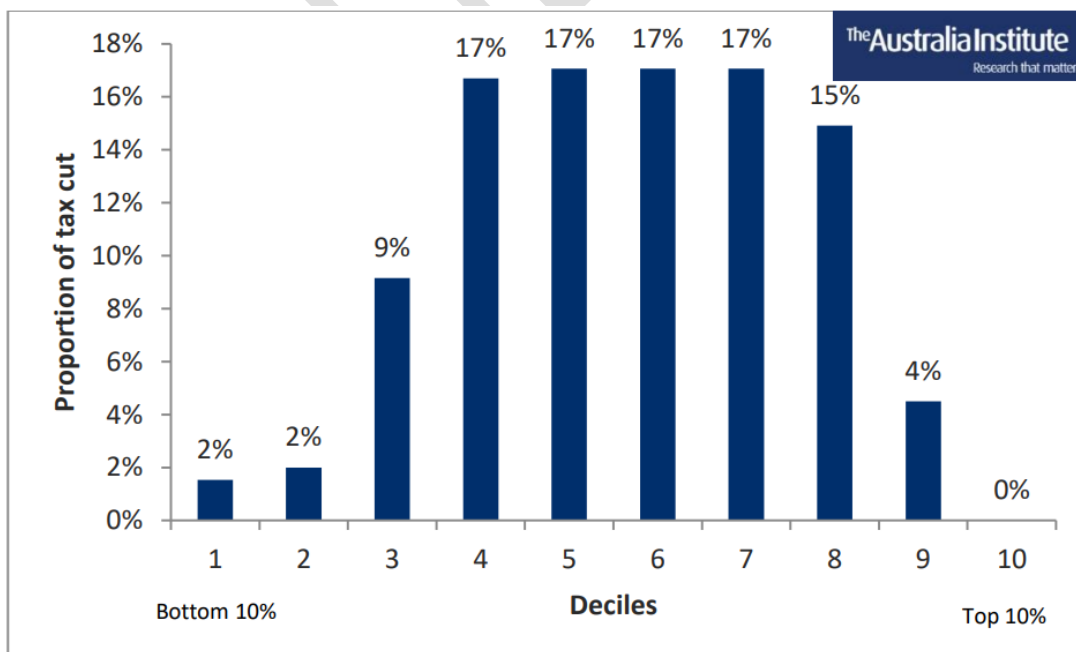
Aren't the tax cuts expansionary?

Cutting taxes can have an expansionary impact on the economy but the size of that stimulus is assisted by several factors, particularly that:

1. Government spending is not cut to fund tax cuts
2. Tax cuts are directed to those who are likely to spend (not save) them (ie those with the highest Marginal Propensity to Consume)
3. Tax cuts are directed to those who will spend the most within Australia's borders on goods and services produced in Australia (ie those with the lowest Marginal Propensity to Import)

The tax cuts proposed by the government come in three stages. Stage 1 expands the LMITO and flows mainly to middle income households. It is expected to cost about \$15 billion over four years. More than 80 per cent of that will go to the middle 50 per cent of taxpayers (those in the 4th to 8th decile).

Figure 1: Income distribution of stage 1(a) in 2018-19

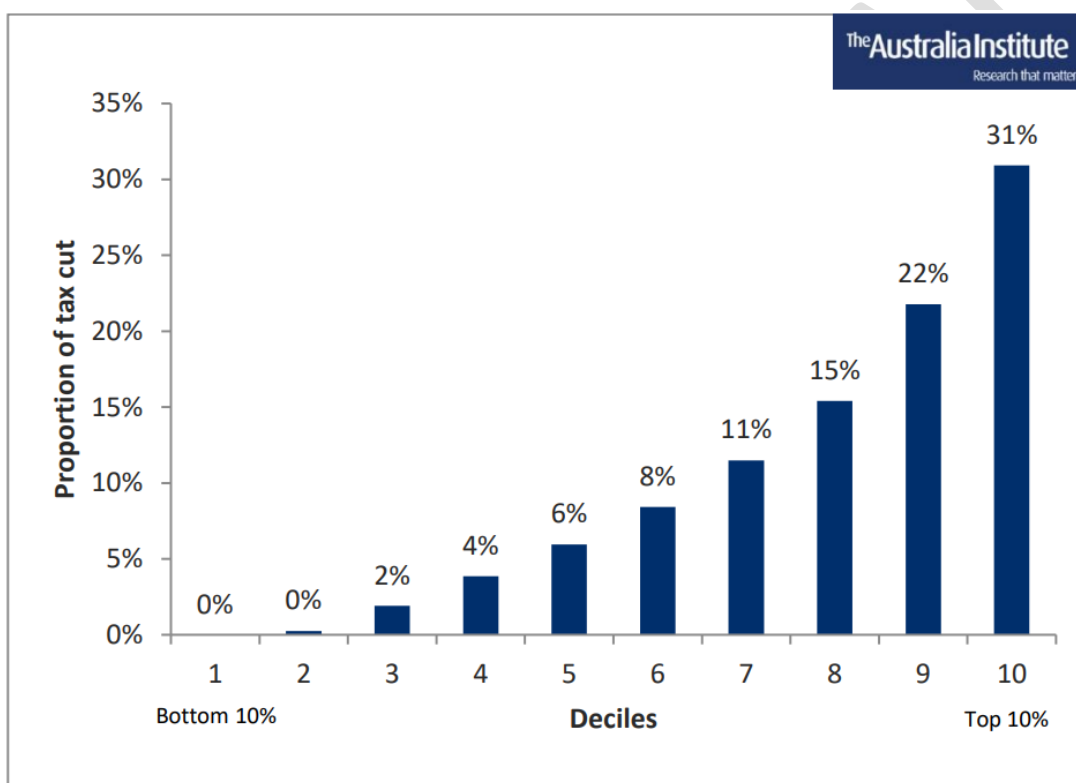


Source: Grudnoff (2019) *Tax targets*, p. 3, <http://www.tai.org.au/content/33-billion-delivered-those-earning-more-180k-unlegislated-income-tax-cuts-new-research>

Stage 2 removes the LMITO from stage 1 while also making changes to tax rates to make sure low- and middle-income earners are not disadvantaged. It also extends the benefits of the LMITO to high income earners.

Stage 3 of the tax cuts does not come into effect until 2024-25 and flows mainly to high income earners. It will cost the budget \$95 billion over the five years and almost a third goes to the top 10 per cent of taxpayers and more than half goes to the top 20 per cent of taxpayers (see Figure 2).

Figure 2: Income distribution of stage 3(a) of the tax cuts in 2024-25



Source: Grudnoff (2019) *Tax targets*, p. 6

Those on high incomes are less likely to spend all their income – they are more likely to save. Economists call this the Marginal Propensity to Consume. This is important for any attempts by the Government to stimulate the economy. Stimulus is more effective if those receiving the funds spend it. This spending creates demand in the economy, more production and more employment, on average. Those on higher incomes spend a smaller proportion of their incomes than those on lower incomes. This means tax cuts aimed at those on higher incomes will have less effect than those on lower incomes.

Those on higher incomes also have a higher propensity to import. Low income earners tend to spend a larger proportion of their incomes on essentials like food, housing, utilities etc. These are more likely to be locally produced. Higher income earners are more likely to spend money on discretionary items which are more likely to be produced overseas. Money spent on imports and overseas holidays creates demand overseas but does not stimulate the Australian economy as much as expenditure on locally produced goods and services does.

Obviously, if the pursuit of the Treasurer's election eve promise of a budget surplus is given precedence over the need to create 'jobs and growth', then the spending cuts needed to offset falling revenue will exacerbate the economic slowdown Australia is already experiencing.

Beware the balanced budget multiplier

While the size of the budget deficit or surplus is often used as a shorthand way of describing whether fiscal policy is expansionary or contractionary, in reality the situation is more complex.

Consider the following:

In April 2019 Treasurer Frydenberg promised a surplus of \$7.1 billion would be delivered over the period July 2019 - June 2020.

Imagine if, in August 2019, Treasurer Frydenberg admits that revenue will be \$10 billion lower between July 2019 – June 2020 than expected and, in response, he proposes cut public spending by \$10 billion to ensure the surplus is maintained.

While the budget surplus would remain unchanged in such circumstances, the amount of economic activity would be lower because some of the \$10 billion left in the hands of taxpayers as a result of lower than expected tax collection will be saved whereas, by definition, all of the government's \$10 billion in proposed spending would have been spent. Put simply, because the government has a higher Marginal Propensity to Consume than households, a reduction in government spending leads to a lower than expected level of economic activity.

Long run impacts of short-run fiscal policy decisions

The pursuit of contractionary fiscal policy when the economy is already slowing will likely have significant effects on both the short run level of activity and the medium term rate of economic growth.

It is easier to *keep* an economy growing than it is to *get* an economy growing which is why, during the early days of the GFC, Treasury gave such forceful advice to the Rudd Government to 'go early, go hard, go households'.⁷ Treasury's advice was based on evidence that economic growth exhibits 'path dependence' which means that once an economy settles into a low growth path it can be hard to push it towards a high growth path. Many European countries have suffered from such 'path dependence' over the past 10 years.

The need for long run fiscal policy flexibility

Much has been made about how, with official interest rates at 1.25 percent, the RBA doesn't have many monetary policy 'bullets' left to fire. But there has been far less discussion about how to make best use of our fiscal policy 'bullets'.

The Morrison Government determination to legislate \$95 billion worth of tax cuts that do not take effect until 2024 will significantly reduce the flexibility of future government to adapt to a rapidly changing world.

While it is possible that wages growth, employment growth and productivity growth will all pick up (as Treasury assumes they will) in the coming years, it is quite possible that they won't. And it is also quite possible that the macroeconomy turns downward in the coming years and that the Morrison Government, like the Rudd Government, will be advised by Treasury (and urged further by the RBA) to significantly boost public spending to boost the economy.

Passing expensive tax cuts today, tax cuts that will not take effect for five years but that will ultimately flow largely to those with the lowest Marginal Propensity to Consume and the highest Marginal Propensity to Import will unnecessarily restrict fiscal policy flexibility over the next five years.

Put simply, guessing today about the tax cuts that are necessary and affordable in 2024 is like buying furniture for a house that hasn't been built yet. It might be fun, but it is neither necessary nor responsible.

⁷ Gittins (2010) *Henry, the believer, had clear view of public interest*, <https://www.smh.com.au/business/henry-the-believer-had-clear-view-of-public-interest-20101226-197ur.html>

Regions matter

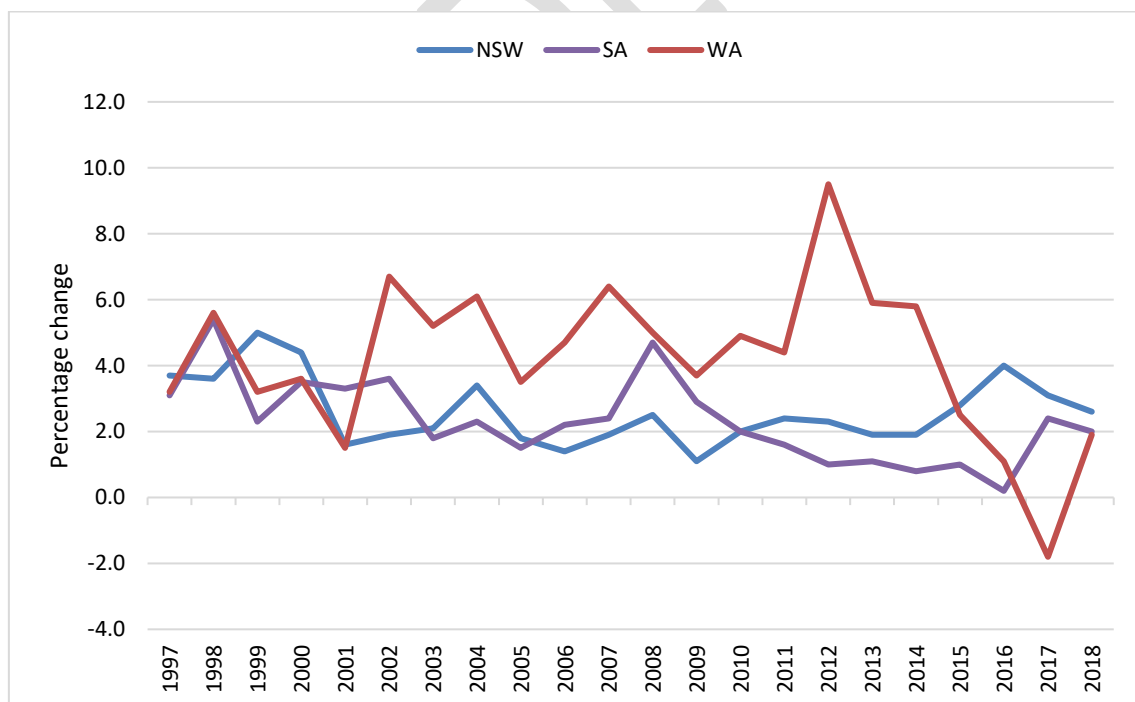
While most commentary about the need for fiscal or monetary policy stimulus refers to the state of 'the economy', in reality different regions and states within Australia often experience quite different economic challenges at the same point in time.

For example, as Figure 3 shows, the WA economic cycle, the NSW economic cycle and the SA economic cycle often have little in common. In 2014 and 2015 when the WA economy was contracting rapidly the NSW economy was actually growing strongly.

Because all Australian states share the same currency it is impossible to target monetary policy to the regions where it is needed, whereas with fiscal policy the opposite is the case. That said, the vast majority of the beneficiaries of the stage 3 tax cuts will reside in our capital cities, while the regions needing the most fiscal stimulus will likely receive the smallest benefits.

While fiscal policy can be aimed at specific regions or states, there is no evidence that the Morrison government has designed the stage 3 income tax cuts with such potential in mind.

Figure 3: Gross State Product percentage change by state



Source: ABS (2018) 5220.0 - Australian National Accounts: State Accounts, 2017-18,
<https://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5220.02017-18?OpenDocument>

A Senate inquiry?

The senate is being asked to rush through \$95 billion worth of tax cuts without even holding an inquiry into the likely impacts. To put this Bill into perspective, that is more money than the government will spend on public order and safety (around \$50 billion), transport and communication (around \$70 billion), assistance to veterans (around \$60 billion) or Aboriginal and Torres Strait Islander health (around \$10 billion).

A senate inquiry could examine:

- The change in economic forecasts since the tax cuts were first proposed
- The size and composition of spending cuts likely to be required to offset the cost of the tax cuts
- The economic consequences of such spending cuts if economic growth remains below trend
- The impact of the tax cuts could have in stimulating the economy in comparison with other forms of fiscal stimulation
- Likely impact of the tax cuts on the size of future surplus/deficits
- Budgetary costs of the tax cuts including a year by year breakdown
- The impact of the tax cuts on Australia's progressive tax system including detailed analysis of the beneficiaries of the tax cuts including by income, gender and age
- The geographic consequences of the stage 3 income tax cuts