Let’s not spend surpluses that are yet to arrive

David Uren, Associate editor (economics), 12:00AM October 4, 2018

With the AAA credit rating secured and a surplus in sight, the Morrison government appears to have decided that budget repair is mission accomplished.
Big spending decisions — the $4.6 billion fix for school funding and the $9bn fix for Western Australia’s GST — are unlikely to be offset by savings. There is still a drought package, a small business tax package and a federal election to come.

Josh Frydenberg has given oblique answers when questioned about whether the strengthened budget position enables the rule requiring spending to be financed by savings to be relaxed. His line is that the government will continue to be prudent, ensuring spending is linked to productivity while delivering essential services.

Scott Morrison clarified last weekend that the budget rule requiring spending to be offset by savings elsewhere still applied, and ministers wanting to spend money had to demonstrate offsets.

However, there would be exceptions. “The government reserves the right to exercise that discretion, but they are the rules,” the Prime Minister said.

The Coalition government’s control over spending has been impressive. It has been helped by low inflation, which has reduced the rise in welfare costs, but credit also is due to Finance Minister Mathias Cormann and to cabinet’s expenditure review committee. Government spending reached $460bn last year, which was $7bn less than predicted in the Abbott government’s ill-fated 2014 budget, despite the failure of many of its savings measures to be implemented. After allowing for inflation, spending has risen by an average of only 1.9 per cent a year under the Coalition, including the rollout of the National Disability Insurance Scheme and a substantial increase in defence spending.

However, Morrison is quite right when he says there are exceptions to the savings rule and the government has indeed exercised its discretion. Each budget statement includes an analysis of the changes that have taken place since the previous statement, separating the impact of policy decisions affecting spending and revenue from the influence of unanticipated changes in economic conditions.

Including budgets and the usual mid-year updates, the Coalition has chalked up 10 budget statements. There have been only three statements where the savings across the current year and next three years of budget projections have exceeded the new spending.

Across the 10 statements, spending decisions have added a hefty $28.2bn to budget costs.

The greater part of that spending — $21bn — has been in the current year before the government rules off the books. The controversial $440 million grant to the Great Barrier Reef Foundation occurred that way, as did the huge $9bn capital injection to the Reserve Bank announced shortly after the Coalition was elected in 2013. Although these one-off spending decisions affect only one year's budget bottom line, they do add to the debt while there is still a deficit.

Budget rules have long been rubbery. The former Labor government had a rule requiring spending growth to be kept to no more than 2 per cent, but the reality was closer to double that. The one rock-hard budget rule — a legislated ceiling on government debt — was removed soon after the Coalition was elected in a deal struck by the treasurer at the time, Joe Hockey, with the Greens.

The International Monetary Fund is a fan of budget rules but says there has to be some sort of sanction for noncompliance and ideally a correction mechanism so that any temporary bending is straightened out later. The fund says noncompliance is widespread — it found that across 49 countries, the rules were broken about half the time. The IMF says having a legislated financial sanction for breaking a budget rule does not work. It urges giving bodies such as the Parliamentary Budget Office an independent mandate to monitor compliance, so that there is a political cost. Rules should have well-defined exceptions to allow for economic shocks. The IMF says there should be a medium-term rule setting a limit on debt and a short-term rule, ideally, governing spending growth.

Australia has a longer history of setting budget rules than most countries. The Charter of Budget Honesty, implemented by treasurer Peter Costello in 1998, requires governments to set out a medium-term budget strategy, which has included rules such as a limit on tax as a share of the economy.

Since its 2013 election, the Coalition has included a separate budget repair strategy statement, including the promise to offset new spending while allowing any improvement in revenue or spending resulting from a stronger economy to flow through to the budget bottom line. The company and personal tax cuts arguably have breached the second element of this commitment.

The budget repair strategy is supposed to remain in place until a "strong and sustainable surplus is achieved". We're plainly not there yet. Morrison's comments indicate that the spending offset rule is still being used to constrain spending ministers but does not control the government.

The IMF's belief that breaching a rule needs to carry a political cost is telling. The most powerful constraint on budget strategy for the past three years has not been the budget rules but the threat by ratings agency S&P Global to strip Australia of its AAA credit rating. That would have damaged the government's political reputation as a good economic manager.

That threat led the government to include revenue-raising measures totalling $18bn in last year's budget, including an unpopular increase in the Medicare levy and a levy on banks.

There is no indication that, with the AAA rating now confirmed, the government is about to open the spending sluice gates, even with an election pending. The discretionary spending will almost certainly be less than the upgrade to the budget from a stronger economy. But the outlook contains hazards, with big risks in the economies of China and the US — quite apart from the trade war between them — that could swiftly halt the global economy's robust growth. Closer to home, no one knows how the deflation of the housing boom will end.

There should be a greater buffer against adversity in the budget before we start spending surpluses that are yet to arrive.