AUSTRALIAN ECONOMIC POLICY: A CRITIQUE

Harold Levien

When the Hawke-Keating Government deregulated the financial system in 1983 it set the stage for massive problems now confronting the Australian economy: the serious current account deficit (CAD), gargantuan foreign debt, the worst unemployment in 60 years, declining investment in productive capacity, declining real wages, and an increasingly inadequate public sector.

Keating's economic policy package launched on 26 February 1992 seems unlikely to have more than the most marginal impact on these problems. The projected 800,000 new jobs over the next four years, even if achieved, would barely absorb the growth in the work force and labour displaced from increased productivity over this period. This paper analyses how the Hawke-Keating Government's policies have played a major role in creating Australia's current problems and presents alternative policy approaches.

The Crux of the Problem

Between June 1983 and December 1991 Australia's gross foreign debt increased from $35 billion to $183 billion.[1] Gross foreign liabilities (debt plus foreign investment) rose from $71 billion to $295 billion.

---

1 Net debt rose from $23 billion to $145 billion. Government borrowing excluding public enterprises currently represents 23% of gross foreign debt.

Income payments to service these liabilities (omitting reinvested earnings) increased from just under $3 billion in 1982-83 to $20.4 billion in 1990-91 - equal to last year's entire income from rural and coal exports. Gross income payments as a percentage of exports of goods and services rose from 11.3% to 39.3%. The ratio of *net* income payments increased from 7.5% to 34%.

The Consequences of Relying on Interest Rates

By removing controls over the flow of funds into and out of Australia, over the volume and direction of bank credit, and over the exchange rate the Government was forced to rely on interest rates and the budget to regulate the economy.

The Government raised interest rates to restrict credit expansion but this accelerated capital inflow especially in the form of debt. While this improved the capital account it substantially increased overseas income payments. The capital inflow also pushed up the exchange rate.

Both the higher exchange rate and higher interest rates hurt export and import-replacement industries thus further exacerbating the CAD. And because the greater part of capital inflow went into company takeovers, the purchase of property and paper securities rather than the development of export and import-replacement industries it increased overseas income payments with little increase in Australia's capacity to make these payments.

High interest rates also encouraged local entrepreneurs to borrow overseas at lower rates. This was further encouraged by the tax deductibility of interest on borrowings irrespective of purpose - which amounts to a government subsidy of all company borrowings. These borrowings further increased overseas payments. Dieter (1991) identifies about $45 billion of this debt as borrowed by several "bad risk" entrepreneurs - including Bond, Elliott, Goldberg, Herscu, Murdoch, Skase and Spalvins - a substantial part of which was used to finance takeovers and property investments rather than to increase or

improve productive capacity from which the servicing costs could be paid.

All of these factors, together with the removal of most controls over capital inflow and outflow, combined to increase overseas income payments to the level where they are the overwhelming reason for the large CAD and therefore rising foreign debt.

High interest rates also slowed down private investments particularly in export and import-competing industries (especially manufacturing and the rural sector) since these industries compete on the international market and cannot pass on higher interest costs as readily as producers for the domestic market. These are the very industries on which a turnaround in the CAD now depends. Yet high interest rates were maintained to encourage sufficient capital inflow to cover the CAD - which in effect amounted largely to covering servicing payments on the capital inflow.

The principal policies to combat the CAD problem (partly created by interest rates) have been to hold down demand through interest rates, fiscal policy and wages policy. The aim has been both to reduce inflation to assist export and import-competing industries and to reduce the demand for imports. But this also slows economic growth and increases unemployment.

Cuts in Public Spending

The Hawke-Keating Government reduced Commonwealth spending as a proportion of GDP from 29.5% in its first year to 23.7% in 1989-90. It is estimated to rise to 26.6% in 1991-92 due to higher unemployment and the initiatives announced in the February Statement. But the ratio is estimated to fall again to 23.3% in 1994-95 as GDP rises without a proportionate increase in public spending.

Continuous reductions in public spending have produced a serious deterioration in most public sector facilities and services including the universities, TAFE colleges, schools, hospitals, child welfare, public

housing and soil conservation services.[2] The CSIRO's funding was cut 27% between 1983 and 1988 although this was partially restored between 1989 and 1991.

The decline in public sector funding was in sharp contrast to funds pouring into private sector property development at an average annual rate of over $6 billion through the past five years. Thus we had the paradox of serious deficiencies in some sectors of the economy critical to Australia's future development and balance of payments while the economy was producing a glut of office buildings and shops. Since much of this property funding came from overseas it further increased the foreign debt.

If the ratio of Commonwealth spending to GDP were to return to the average of the period 1981-82 to 1985-86 (28.9%), taking into account the present higher level of unemployment without which the present ratio would be lower, this would provide for another $12.5 billion expenditure per annum. This would rapidly overcome public sector deficiencies and raise the quality and accessibility of services.

There would also be funds for substantial assistance to export industries and for major development projects such as reconstructing the rail system (on a far bolder scale than the $454 million project in the February Statement) and expanding urban public transport both to reduce future reliance on oil imports and lessen environmental damage from motor vehicles.

---

2 A few examples: NSW Health Minister, Hannaford, stated on March 19, 1992 that NSW had a backlog of hospital building and repairs of over $2 billion which the Government was unable to fund. The Department of Employment, Education and Training (1991) projected the level of unmet demand for TAFE places in 1992 at 150,000. The *One Nation* package provided funding to meet about one-third of this demand. The Australian Vice Chancellors' Committee in a survey of unmet demand for university places estimated this to be between 13,000 and 20,000 in 1990 and between 20,000 and 30,000 in 1991. Preliminary figures indicate unmet demand in the vicinity of 50,000 in 1992. There has been a 19% decline in real per capita operating grants for university students since 1976 according to *Quality of Higher Education* (February 1992) issued by FAUSA (Federation of Australian University Staff Associations).

Even if the Government wished to return to the current proportionate size of the public sector - after a transition period of stimulus to attain a more fully employed economy - the greatly increased revenue base and reduction in unemployment payments in an expanded economy would permit a substantial increase in public spending. To illustrate: the current unemployment level (including discouraged job seekers), even allowing for around 3% structural unemployment, results in a loss of annual output around $36 billion.[3] The annual cost to the Commonwealth in tax revenue foregone is about $12.6 billion since the tax clawback (from direct and indirect taxes) is around 35% of the growth in GDP. Since unemployment allowances cost over $7 billion the annual cost to public revenue (omitting additional health and welfare costs) is around $20 billion. This is equal to total Commonwealth spending on health and education at all levels in 1990-91.

A substantial increase in public sector spending could be largely funded from economic growth. A $4 billion addition to capital expenditure in labour intensive areas with little direct import component (such as railway development, roads, education, public housing) would increase employment by about 120,000.[4] Taking into account the tax clawback

---

3 Adding the official unemployment figure of 10.5% to the ABS estimate of discouraged job seekers actual unemployment was at least 12.5% in March 1992. If we accept 3% structural unemployment then annual output foregone from deficient demand would be 9.5% of current GDP of about $380 billion.

4 $4 billion spending should increase GDP by at least $6 billion assuming a very conservative national income multiplier of 1.5. From this $6 billion, tax revenue should increase by $2.1 billion assuming a tax clawback of 35%. With 60% of spending on wages (a conservative figure for such spending) wages would increase $3.6 billion. With average weekly earnings around $30,000 employment can be expected to increased by 120,000. Treasury estimates 60% of new employment is drawn from those on unemployment allowances. The remainder come from those not eligible for the dole and from increased workforce participation as the economy expands. Dole recipients would therefore decline by 72,000. With average unemployment payments of $10,000 per dole recipient unemployment payments would be reduced by $720 million. Adding $720 million to the tax clawback of $2.1 billion and subtracting the total from the original $4 billion stimulus there is a funding residue of about $1.2 billion which the Government would need to borrow.

and reduced payout on unemployment allowances the budget deficit would increase by less than $1.2 billion. This should create little funding difficulty in an economy where, the ABS estimates, this year's private investment will decline by $8 billion (at constant prices) compared to 89-90.

Arguments Against Increased Public Spending

The arguments against increased public spending are usually based on three grounds: it will have little impact on unemployment; it will increase the CAD; and it will be inflationary.

The first argument is that increased public borrowing (where the spending is not financed by higher taxation) will push up interest rates which will discourage (crowd out) some private investment. Yet at a time when private investment has fallen $8 billion another $1.2 billion of public borrowing should not push up interest rates. No one suggests that this level of additional *private* borrowing for investment should be discouraged because it may push up interest rates.

The second argument is in two parts: because of the higher levels of borrowing there will be a net increase in foreign debt; and the economic expansion (inconsistent with the first argument) will lead to an unaffordable increase in imports. Both factors would exacerbate the CAD. Again, no such argument is used against private investment.

The third argument was used before the recent decline in inflation: a higher level of public spending is inflationary through increasing trade union bargaining power. However, the purpose of the Accord was to permit economic expansion without stimulating wage inflation. To reduce risk of inflationary pressures from economic growth, training and retraining programs could be expanded to provide the skills necessary for the expenditure projects. Once again this argument is not used against private investment although the impacts could be identical.

One of the many paradoxes of government economic policy has been that, despite the above argument which has often influenced policy

decisions, the government has contributed to inflationary pressures in several ways.

Heavy cuts in Commonwealth grants to the States have frequently forced State Governments to raise taxes and charges, many of which enter into the C.P.I. In several annual quarters these increases have been the largest or among the largest components in the C.P.I. rise.

Rises in house prices and rentals have also been major factors in the C.P.I. rise. The Commonwealth Government has significantly contributed to this both through reducing the supply of, and raising the demand for, housing. Allocations for housing have fallen from $1328 million in 1984-85 to $1118 million in 1991-92 despite a 63.5% increase in the housing component of the C.P.I. and a 13% increase in population. To maintain real per capita funding the 1991-92 allocation would need to have been $2337 million - well over 100% greater. Meanwhile the Government's large immigration program has significantly increased the demand for housing.

The arguments against higher public spending involve acceptance of massive unemployment and idle capacity unless the stimulus comes from the private sector. But the private sector stimulus has not occurred. In any case increased public investment will often be of immense benefit to the economy and society and assist the long-term reduction in the CAD whereas many private investment projects, such as property development, may yield comparatively little gain to the economy.

Some economists argue against expanding public spending on the grounds that private sector recovery may be under way by the time the public spending takes effect.[5] Yet with over a million unemployed it would take six years of exceptional growth to make substantial inroads into unemployment.

The monetarist thesis that the public sector crowds out the private sector could perhaps give way to a reverse thesis: that the private sector and private sector perceptions are crowding out the public sector!

---

5 Max Walsh argued along these lines in his *Sydney Morning Herald* columns after the February 1992 Statement.

It can be argued that public sector spending should be at the forefront of any recovery plan for three reasons.

First, as technology increasingly replaces labour with capital (such as robotics and computers), employment will depend more and more on expanding the services sector, a large part of which lies in the public domain: education, health, public transport, welfare services, environmental protection ... Therefore, unless public services are substantially expanded it seems highly unlikely that we can reduce unemployment to the level of the 60's.

Second, the nation's future export potential, economic growth, and living standards depend on a substantial increase in spending on education, scientific research and other social infrastructure - all substantially the responsibility of the public sector.

Third, the quality of life and welfare of a civilised, affluent community depends importantly on the services provided by government.

Current economic policy appears to ignore this reasoning.

One by-product of our continuing high levels of unemployment is the downgrading of environmental impacts of development projects such as mining, logging and paper mills. Public pressure becomes intense for almost any development which leads to employment.

Is Capital Inflow Required Because of Inadequate Savings?

It is frequently argued that the Australian economy does not generate sufficient savings to fund investment and that high levels of capital inflow are therefore required. Four points need to be made in reply:

First, high levels of capital inflow have been necessary to cover the income payments generated by previous capital inflow, much of it for foreign takeovers of local firms and purchase of Australian property and

paper securities. Additionally, capital outflow has generated much capital inflow.[6]

This blow-out in overseas income payments could have been greatly reduced by monetary and fiscal measures against undesired capital inflow - such as the 1973 variable deposit ratio or withholding taxes - and reducing foreign takeovers.

The latter could be achieved in two ways: establishing a National Industry Corporation (perhaps capitalised from Super bonds referred to below) to buy out, or take strategic holdings in, viable firms which entrepreneurial borrowing sprees have bankrupted or placed at risk, such as the Linter Group and John Fairfax; and through more stringent application of the discretionary powers of the Foreign Investment Review Board to prevent the overseas takeover of highly successful firms such as Bundaberg Sugar.

Second, a great deal of Australia's savings make a marginal contribution to the economy. As mentioned above, investment in office buildings and shopping centres over recent years has produced a glut of these facilities in sharp contrast to the deficiencies in the public sector.

The superannuation-wage deal provided the Government with an unprecedented opportunity to channel the increased savings into investment projects of great worth to the economy. Instead, it left it to the market. Last year $6.4 billion flowed into superannuation funds,

---

6 While capital outflow has declined considerably (to $1.5 billion in 1990-91), in 1988-89 it amounted to $11.4 billion. Since capital outflow leads to capital inflow (Australian dollars are sold for foreign currency) it played an important role in expanding the CAD where remittances from the recipient country were less than Australia's remittances on the offsetting inflow-which was frequently the case. We have often faced incongruous situations where the Government and its instrumentalities borrowed overseas to relieve pressure on the Australian money market; and the Government has restricted borrowing programs to fund essential infrastructure so as to hold down interest rates. At the same time funds were flooding out of Australia. And the greater the capital outflow the higher the interest rates needed to attract the required capital inflow. Removal of controls over capital outflow has also facilitated the flow of funds into tax havens reducing both the supply of investment funds and the tax base.

but this predominantly went into property development, shares and other paper securities.

To take advantage of the increase in superannuation savings the Commonwealth could issue Super bonds with substantial tax concessions designed to gather up most of these funds. Billions of super funds would then be available for investing in essential social infrastructure, assistance to export oriented industries and a National Industry Corporation referred to above.

Third, tax changes could encourage savings through restricting tax on interest-bearing deposits to real rather than nominal interest. Currently 8% interest when inflation is 3% provides a 1% net return for income earners on the top marginal tax rate. This either discourages savings or encourages a diversion of savings into capital appreciating assets such as property or shares.

Tax on real interest would need to be supplemented by further tax concessions to make the return sufficiently attractive to impact significantly on savings decisions. A maximum 20% tax on deposits where funds are lent to specified areas of national significance may achieve this objective. In this way both the pool of savings would be increased and the direction of their utilisation addressed at the same time. Such a proposal could readily be funded from abandoning or modifying dividend imputation, currently costing the Government around $5 billion annually in revenue foregone. Dividend imputation primarily benefits high income earners while at the same time encouraging the flow of savings into paper securities.

Fourth, to the extent that capital inflow is inadequate to fund the CAD at the exchange rate/interest rate settings desired by economic policy makers, the Government could borrow overseas. Because interest rates on Government borrowings would be significantly below the rates required to induce private capital inflow the current account costs of borrowing would be substantially less. Moreover, while such borrowings would initially increase the budget deficit, the lower CAD and the lesser need to lock in economic policy to the money market's perceptions would permit more expansionary policy. This would

increase Government revenue from which it could fund the cost of borrowing.

Other Questionable Policy Actions

There are other policy actions springing from the Government's free market approach which have exacerbated or will exacerbate the CAD.

The Government has time and again failed to provide funding for small firms, the CSIRO and the Universities in the commercial development of many brilliant new products. The belief in leaving product development to entrepreneurs ignores their normally short-term vision in the desire for quick returns. The result is that very many high tech products and processes have had to be commercially developed offshore, losing Australia opportunities for earning considerably more export income than is possible from licensing arrangements.

The latest example is the University of NSW's vanadium battery. Despite a very large potential, the project has been struggling for research funding and has to rely for commercial development on a Thai and a Japanese firm. In the case of the C.S.I.R.O.'s gene shears, again no local entrepreneurs would take up commercial development. A French and a U.S. firm agreed to jointly develop the product involving a modest capital outlay of $44 million. Although the C.S.I.R.O. will be a third partner, a large part of the expected future annual earnings of hundreds of millions of dollars will now accrue to foreign firms.

The decision in the February 1992 Statement to establish an Australian Technology Group with a capital base of $30 million is a tiny step in the direction of Government assistance. But rather than fund the commercial development of products it will concentrate on "identifying research with commercial potential ... and marketing research output" (*One Nation*, February 26, 1992). Professor Adrienne Clarke, the new CSIRO Chairperson, commented that "we don't need any more broking roles (like the ATG) ... "we're finding there is ... little money for (development of these products) in this country" (*Face the Press*, March 18, 1992, SBS television).

This approach to the development of Australia's export potential in its most serious economic situation in sixty years is in stark contrast to the Government's defence funding. Although Australia has rarely faced less threat to its security it is engaged in its most expensive peacetime defence re-equipment, costing over $2 billion per annum, involving state-of-the-art weapons with a large import component.

Australia more urgently needs something like an Exports Development Corporation with about $100 million capital (less than one sixth the cost of a new submarine) and a charter for maximising long term balance of payments gain to the Australian economy through funding the commercial development of science based products from the C.S.I.R.O., the Universities, medical research institutes, and firms too small to be able to fund their own product development. It would therefore be quite unlike the AIDC, the Commonwealth Development Bank and other financial institutions which the Government has previously established to assist development. These have had short-term profit-based criteria like other commercial firms.

When we take account of the economic and human costs of current levels of unemployment such funding would be a very small price to pay to limit these costs. Indeed it could be one of the most beneficial investments ever undertaken by the Australian Government.

Tariff cuts are another problem. They have increased imports and adversely affect many efficient local industries such as food processing. Unlike Japan and many very successful European countries, the Government is determined to continue with its purist view of protection even at the cost of adding substantially to unemployment when there are no expanding industries into which the displaced labour can move. There is certainly a sound argument for reducing protection of industries which can never become competitive with overseas industries. But even here it seems wiser to await an expanding economy.

Passenger motor vehicles are our most expensive consumer import costing annually about $2.2 billion. Rather than reducing the 20% sales

tax to 15% as in the February 1992 Statement[7] thereby encouraging motor vehicle imports, it would have made more balance of payments sense for higher sales tax or higher tariffs on vehicles over say $25,000 to reduce this huge contribution to the CAD. The higher tariffs could be limited to perhaps three years. Hewson's consumption tax would reduce the present 30% luxury motor vehicle tax to 15% and therefore promote motor vehicle imports even more. He would extend the boundaries of economic (and ecological) irresponsibility by also substantially reducing petrol tax, thus further exacerbating the CAD.

To reduce imports by about $1 billion requires a reduction in aggregate demand of about $4 billion. This will increase unemployment by about 120,000. But higher, albeit temporary, tariffs on selected goods (such as expensive motor vehicles, alcohol, processed foods and confectionery) which would not foster the expansion of high cost inefficient industries, together with higher sales tax on goods which are entirely imported (such as TV sets, VCR's, hi-fi radio, microwave ovens), could achieve the same objective with much less impact on unemployment. Tariff increases could be accompanied by assistance for industry restructuring into selected areas where Australia has potential cost advantages, such as processing of minerals, wool, food and new high technology products.

The Commonwealth Government's failure to underwrite Australia's wheat crop in 1991 reduced the wheat acreage by 1.3 million hectares according to the Grains Council. This will reduce the wheat crop by about 2 million tonnes and reduce export returns by $360 million. The contingency underwriting requested by the wheat industry of around $20 per tonne could have cost the Government around $260 million. Since the price of wheat has risen to $180 per tonne it would not have cost the Government a cent. But even if it had cost the Government as much as the contingency estimate the contribution to export income and retaining wheat markets might have led a Government more determined to reduce the CAD and unemployment to support the industry in this way.

---

7 The Government could have doubled the outlay on improving the railways with just two years of the estimated revenue foregone from this sales tax cut.

The Government's decision to sell Australian Airlines and 49% of Qantas will almost certainly lead to substantial overseas investment in the airlines and therefore again increase overseas remittances. By encouraging the introduction of new domestic airlines the government is ensuring a substantial increase in the import bill. In 1990 Mr Keating, as Treasurer, cut $630 million off the amount Qantas was permitted to borrow overseas for new aircraft to meet its expansion plans. Yet Qantas is one of Australia's largest foreign exchange earners.[8] In preceding years no action was taken to stop some of our more reckless entrepreneurs from borrowing billions of dollars overseas for takeovers which, as mentioned earlier, greatly increased our CAD. Currently the Government is further harming Qantas by depriving it of badly needed capital funds and extending competition on some of its lifeline routes.

The introduction of an overseas competitor to Telecom will greatly increase future income debits on the current account because of this industry's huge profit potential. Optus' planned spending of $4 billion on infrastructure over the next five years, much of which will simply duplicate Telecom's facilities, will increase foreign borrowing as well as absorb scarce savings.

The decision to introduce Pay TV appears to take no account of its impact on the balance of payments. It will lead to substantially increased import expenditure on consumer and capital equipment and on programs for the new channels. It will also absorb potential savings which could otherwise be available for industry development. Because it will almost certainly involve overseas investment it will further expand Australia's overseas liabilities.

---

8 Qantas' net contribution to Australia's balance of payments on current account in 1990-91 was $1,772 million. After taking account of aircraft purchases (which vary from year to year) the overall contribution to the balance of payments was $408 million. In addition Qantas claims the contribution from import replacement was $1.6 billion. Because of Qantas' tiny equity capital, which the Government has refused to remedy, Qantas has large offshore borrowings for purchases and leasing of aircraft. Last year the servicing of this debt cost $271 million. This is not only a cost to Qantas; it is also a further large burden on the CAD.

Government at State and Federal level now require environmental impact statements when firms undertake major investments which may have an adverse impact on the environment. There is an equally strong argument for the Australian Government to require a balance of payments impact statement when large investment projects are planned or when cabinet decisions are proposed with potential large balance of payments implications.

Conclusion

Current economic policies to reduce the CAD have caused massive unemployment and an impoverished public sector. Yet these policies undercut the very industry development and skilling of the work force needed to overcome the current account deficit. At the same time the Government pursues policies which exacerbate the deficit. All this is done in the name of economic rationality. If Orwell and Keynes joined us today one would probably think geography and the other, time, had played a cruel joke.

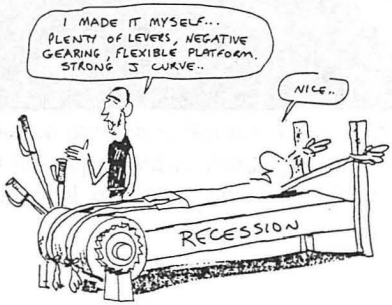
REFERENCES

Australian Bureau of Statistics (ABS),*Foreign Investment, Australia*, Cat. No. 5305.0.

ABS, *Balance of Payments, Australia*, 1990-91 1982-83, Cat. No. 5302.0.

ABS, *Imports, Australia* 1990-91, Cat. No. 5426.0.

ABS, *Private New Capital Expenditure, Australia, Actual and Expected Expenditure*, Cat. No. 5626.



ABS, *Assets of Superannuation Funds and Approved Deposit Funds*, Cat. No. 5656.

Australian Government, Department of Employment, Education and Training (1991), *Employment, Education and Training Initiatives*, AGPS, Canberra, November.

Australian Government, Department of the Treasury, *Budget Paper No. 1*, 1984-85; 1991-92, AGPS.

Australian Government (1992) ,*One Nation*, Statement by the Prime Minister 26 February.

Dieter, H (1991), Aspects of Australia's Foreign Liabilities: A Mortgage for Future Generations, *The Australian Quarterly*, Winter.