THE KENNETT CUTS: HOW NECESSARY ARE THEY?

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The 1980's were undoubtedly Labor's decade in state politics. At various points in time during the 1980s the ALP formed Governments in all of states. In some states - such as Victoria and South Australia - the ALP remained firmly in power for most of the decade. Most of these Governments have been swept from office, and the state tier is now basically back in the hands of the Conservative parties. Some interesting research has been done on Labor's rise to power in states like Victoria (Costar and Hughes eds., 1982). There have also been some penetrating post mortems of the Labor era (Considine and Costar, eds., 1992), as well as some important contributions on Labor's economic strategies (Evatt Foundation, 1989). Little, however, has been written on how the Conservative parties managed to regain control of the states, what it is they have done now that they are back in power, and the nature of the reform agenda they have put in place since resuming control.

This paper attempts to fill this gap in the literature by focusing on the Kennett Government in Victoria, elected to office in October 1992. The ALP was swept from office after ten years of Government, with a

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6% swing against it. Underpinning the Coalition's success was a widespread belief that the Labor Government was an incompetent economic manager, and had left both the State finances and the Victorian economy in very poor shape (Costar and Economou, 1992).

What makes the Victorian situation interesting is the large gap that has subsequently emerged between what the Coalition promised it would do during the election campaign to fix the economy and state finances, and what it has done after being elected. During the election campaign senior Coalition spokespersons repeatedly claimed that the election promises made during the campaign were all that were necessary to resolve Victoria's problems. The then Opposition leader, Jeff Kennett, insisted to journalists that his Party's policies had been framed "on a worst case scenario basis"; no Victorian, he said, would be one dollar worse off under a Kennett Government. In an attempt to prove their case, the Coalition parties removed Des Moore - one of their leading economic supporters - from their mooted audit team mid-campaign after he suggested on radio that the Victorian public service was overstaffed to the tune of some 30,000 employees.

During its first month in office the Government broke many of its election pledges in the way it claimed it would not do. The Government claimed that the state finances were in much worse shape than it had thought possible prior to the election, and found it necessary to introduce a string of very unpopular budgetary and industrial relations reforms. As part of the cuts some 44,000 public sector workers have lost their jobs, which exceeds the job cuts estimate made by Des Moore during the election campaign, and which cost him a position on the audit team (*The Age*, 7 April, 1993). These cuts have not been popular. On November 10, 1992, the Government watched over 100,000 people close down the central business district in a mass protest march against its reforms. Further tough measures provoked another major demonstration only a few months later.

The Government's opinion poll ranking declined in its first few months in office, and some have argued that were the voting patterns of the federal election to be replicated at the next State election, the Victorian Liberal Party would once again be sitting on the opposition benches (*The Age*, 22 March, 1993:3). Many factors have played a part in this

slip in fortunes, but none more important than the two Economic Statements brought down on October 28, 1992 and April 6, 1993, together with the string of revenue measures announced in the first few months of 1993. Introduced amidst a high profile publicity campaign, these Economic Statements involved large cuts in Government spending, large increases in taxes, and a substantial increase in borrowings to fund the largest public sector redundancy program ever seen in this state.

So carefully has the Government crafted its "economic catastrophe" line and so apparently financially inept was the previous Government that few have questioned the validity and necessity of the Government's harsh budgetary strategy. With only one or two notable exceptions (Davidson, 1993; Barker, 1993), the press has been very supportive of the Government's actions. For example, in a typical editorial, *The Age* recently commented that:

> ...the deeply troubling truth is that Victoria cannot afford the services we have all come to expect as our right during the past few decades. The state has suffered so badly as a result of mismanagement by the previous Government and the prolonged economic downturn that we are now being forced to do with fewer hospitals, fewer schools, fewer community services (*The Age*, 7 April, 1993:15; for a stronger position see the *Financial Review*, 7 April, 1993:7)

But are the state finances in the sort of mess claimed by the Government? Is Victoria genuinely going through such a terrible budgetary phase that only the most drastic fiscal medicine will suffice? These are the questions to which this paper is addressed.

The paper is divided into four parts. The first part outlines the key budgetary measures announced in the Economic Statements, and documents their severity by drawing upon budget data. The second part summarises the Government's explanation for these tough Economic Statements. Next the paper examines the findings of the recently released Audit Commission, which was established soon after the Coalition won the election. The Commission had as its main objective an assessment of the state of public finances in Victoria, and its findings are crucial for the Kennett budgetary strategy. The need for the Economic Statements and their appropriateness concerns the final part

of the paper. Also considered here is the adequacy of the Audit Commission's findings.

What Did the Budgets Involve?

Since coming to office the Kennett Government has brought down two Economic Statements in the space of six months, and in between has announced a string of new tax and revenue initiatives. Table 1 demonstrates the financial impact of these announcements on the main budget aggregates.

Table 1 shows how the Government's measures will have affected the main budget aggregates in the four years to 1996 by comparing the Government's estimates of outlays, revenues and financing transactions in 1995/6 relative to the last budget brought down by the ALP in September 1992. In broad terms the announcements involve a short term increase in total Government taxing, spending and borrowing. Whereas the latter two might seem odd given the Government's desire to reduce the size of the public sector, the increase in spending and borrowing is a consequence of some $2b in redundancy payments, to be financed through additional borrowings. These will add to the Government's interest bill in the short run, but over the longer term the savings on wages and salaries should ensure that the net effect is a lower level of current spending and a fairly rapid repayment of debt. It is presumably for this reason that the redundancy payments have been classified as capital outlays rather than current outlays in the way that the Australian Bureau of Statistics has done (Australian Bureau of Statistics, *Government Finance Statistics, Australia,* 5101.0).

In the first couple of years, the increase in capital outlays is at least partially compensated by some rather savage reductions in current spending. Particularly hard hit are the departmental operating budgets, which by 1994/5 will be some $1.1b less than they would have been under the last ALP budget.

Table 1: The Effect of the Mini Budgets on The Main Aggregates ($m)

	The last ALP Budget, 1992/3 ($)	The impact of the two Economic Statements in: 1992/3 ($)	1995/6 (in constant 1992/3 prices) $	Change in Budget Aggregates arising from the two Economic Statements Between 1992/3 and 1995/6 Budget (column 3 less column 1) $m	%
Total Current Outlays	12797	12192	11653	(1144)	-9
Total Capital Outlays	1650	2450	1382	(268)	-16
Total Outlays	14447	14653	13035	(1412)	-10
Taxes, fees, fines	5720	6098	6454	734	13
Public Authority Dividends	587	587	685	98	17
Other	181	181	171	(10)	-5
Total Revenue	6489	6867	7310	822	13
Grants	5334	5322	5030	(303)	-6
Revenue and Grants	11822	12189	12341	518	4
Total Deficit	2625	2454	694	(1930)	-74
Current Account Deficit	1847	865	(72)	(1919)	-104
Capital Account Deficit	777	1589	766	(12)	-2

Source: Victorian Government, *Restoring Victoria's Finances, Stage 2*. April 6, 1993.

The increase in tax revenues and public authority dividends also warrants comment. The two largest imposts involve two novel and highly regressive taxes: the State Deficit Levy (a $100 charge on each household irrespective of means), which is to raise $180 million, and the introduction of "special dividends" on the main State Trading Enterprises (SECV, Gas and Fuel and Melbourne Water), which requires them to arbitrarily increase their charges by 10%, with the proceeds being paid straight into the consolidated fund. In effect, the State's utilities have been turned explicitly into tax collectors for the

first time in the State's history. These special dividends in conjunction with existing dividend requirements mean that the State's utilities are now being milked by the Government to the tune of almost $1 billion per annum, which means that the Government's privatisation program is now almost economically unviable given the current revenue problems of the State budget (Gill, 1993; Ries, 1993).

In sum, while outlays overall are projected to increase in the first couple of years, by 1995/6 they will have fallen by some 10%. Current outlays will bear most of the burden of restraint in the early years, and capital outlays thereafter. Revenues are tipped to increase by 13% by 1995/6, while the State's $2.5b deficit is to fall to around $600 million. The current account deficit is projected to disappear by 1994/5, after having been $1.5b at the time of the last ALP budget.

How severe are these measures? It would be difficult to find budget documents that contain larger discretionary reductions in spending or larger increases in taxes at any time in the State's history. The 1988/9 budget, for example, described the 3% real reduction in outlays announced for that year as involving "the lowest rate of growth (in Government spending since) the early 1960's" (Victorian Government, 1989: 4). The Liberal Coalition Government's budgets involve a 10% real reduction in spending, with most of the cuts focused on the operating budgets of key Government departments (the 1988/9 budget put most of the burden of restraint on to capital outlays). The State Government workforce (excluding the utilities) will fall from 195,347 in 1991 to 173,048 by 1993, and to 159,000 by 1995, a reduction of 19%. The public sector workforce in total will fall from 254,834 to 227,674 between 1992 and 1993 and to 210,000 by 1995, a total fall of 18% (Victorian Government, 1993b:6-19).

Why did they do it? The Government's View

The Government's fiscal medicine is extremely harsh. But it is harsh medicine for harsh times, says the Government. Reference is made to three key indicators, all of which are said to show unambiguously that Victoria is in a state of budgetary crisis.

The first, and probably most frequently cited, is the actual level of debt, which it is claimed has become unsustainably high (Victorian Government, 1992: Ch 8; Victorian Government, 1993a:1-17, Ch 7). The Government presents data comparing Victoria's debt with that of New South Wales and Queensland, which show Victoria's net public sector debt at 32% of Gross State Product (GSP) to be much higher than that of the two other states (New South Wales 17% of GSP and Queensland 15% of GSP).

Large public debts lead to large interest payments, which soak up revenues that might better be deployed elsewhere. It is these interest payments which compose the second "crisis" indicator used by the Government to demonstrate the magnitude of Victoria's budgetary problems (Victorian Government, 1992:8; Victorian Government, 1993a: 1-4ff). The argument is that because Victoria is so deeply in debt, interest payments have been climbing to unsustainable levels. Data are presented that show Victoria's public sector interest costs account for 23% of revenue and grants, and that budget sector interest payments account for 28% of own source revenues.

The third argument in favour of the cuts is arguably the most important. The argument is that debt is being accumulated not on capital, but current spending, a practice which the Government claims should not be followed under any circumstances (Victorian Government, 1992: 11ff; Victorian Government, 1993a:1-4; Ch 3). The Government is alluding to a distinction drawn in the economic literature between two different types of spending, and the principles governing their financing. On the one hand there is current spending on costs like wages and salaries, which most economists argue should be covered by current revenues such as taxes, fees, fines and grants from higher levels of Government. On the other hand is capital spending. Many economists argue that it is appropriate for Governments to borrow for capital purposes because otherwise Governments might face large swings in spending when a new major capital project like a dam needs to be built. They also are in favour of borrowing for capital purposes on equity grounds, in that only through long term borrowings is it possible to charge those generations that benefit from the existence of the capital item being built (Musgrave and Musgrave, 1980; Heilbroner and Bernstein, 1989).

The Kennett Government claims that Victoria has a deficit on its current account budget, and this is its major budgetary problem. The last Kirner Government budget bequeathed the state a current account deficit of over $1.5b, which translates into increased debt. Interest payments will grow, which in turn will require more borrowing and more interest payments, and so on. A combination of unsustainable debt levels, rising interest costs, and a large current account deficit forms the crux of the Government's explanation as to why Victorians must endure a period of harsh fiscal medicine.

Was it Necessary?

The Audit Commission

One of the Government's first acts on coming to office was to appoint an Audit Commission, charged with the responsibility of assessing the severity of the State's financial problems, identifying the reasons for Victoria's financial demise, and suggesting measures that might resolve these problems. Chaired by Sir Roderick Carnegie in its first few months, the Commission brought down its findings on May 6th under the leadership of Professor Bob Officer, a member of the Graduate School of Management at Melbourne University and a Director of the Institute of Public Affairs.

In a two volume report spanning over 700 pages, the Commission's findings were exactly what the Government would have wanted to hear. The Commission concludes that the State finances are indeed in a mess. The deficit, at over $2.5b, is larger than had earlier been estimated (Victorian Commission of Audit, 1993: Vol 1:9), and State debts, at almost $70b, are over $10b more than the Treasury had previously calculated (Vol 1:10). The Commission is highly critical of the budgetary strategy pursued by the ALP throughout the 1980's for its over dependence on debt-funded spending initiatives. Using Grants Commission data, the Commission argues that Victoria has a much larger public sector than other States, and one that has grown more rapidly than other states in recent years:

> ...Victoria's recurrent budget deficits are due to spending in excess of that required to provide an average level of public services...Efforts to restore stability to Victoria's finances must inevitably focus more on reducing spending than increasing state taxation (Vol. 1, pp 103-4).

This tendency toward overspending is identified as the root of the budgetary problems, with profligacy being nominated as the main cause behind the emergence of the current account deficit in the first place. The Commission argues that this itself reflected the way that the Labor Governments had become captured by various public sector unions (cf Volume 2), particularly those in education, health and transport. The Commission also singles out the Kirner Government for a number of stinging criticisms concerning some dubious financial arrangements it had engaged in as a means of avoiding the Global Borrowing Limits. Targeted for strong criticism are the policies of the last Kirner budget, which the Commission argues,

> were unsustainable over anything other than the very short term...Without significant policy change, Victoria's credit rating would almost certainly have been downgraded yet again within the next five years (Vol. 1:130).

The Commission takes a quite different view of the current administration, giving a glowing endorsement of the Coalition's budgetary strategy. The Commission goes so far as to "commend the Government for the manner in which it has sought to tackle the State's financial problems" (Vol. 1:149).

An Alternative View

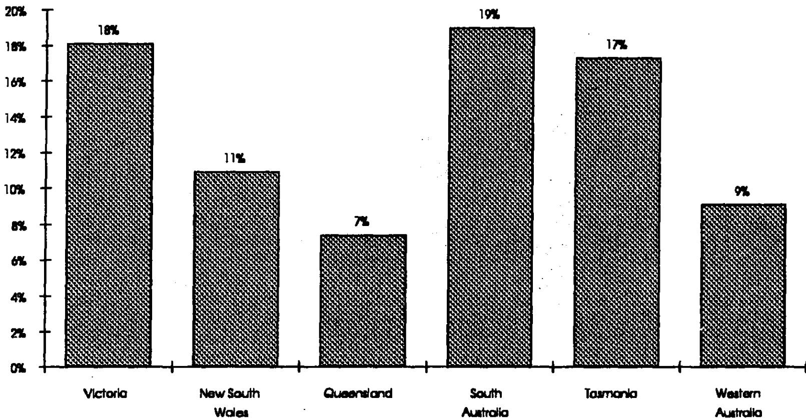
To what extent is the Audit Commission's unqualified support for the Government justified by the available evidence? At issue here is not whether Victoria has budgetary problems. Rather, are the State's finances so catastrophic that the Government has had little choice but to reduce severely Government spending, shed 44,000 jobs, and introduce a swag of very regressive tax imposts.

The three key "crisis" indicators advanced by the Government (and the Audit Commission) warrant more careful analysis.

State Debt

In its attempt to demonstrate that Victoria has a debt crisis, the Government has tended to refer to the absolute level of debt in dollar terms, that is, $32 billion. This is a very poor indicator of debt. First, it ignores the uses to which the debt has been put. This is a serious shortcoming because much of the State's debt has been accumulated not by Government Departments, but by the State's profitable utilities, such as the SECV and the Gas and Fuel. They use debt to finance activities that are self financing (that is, they have no impact on the State budget whatsoever). When the debts of these commercial enterprises are excluded, the State Government net debt falls from around $32b to less than $19b, or from around 32% of Gross State Product to less than 19%.

Figure 1: Net Debt[1] of State General Government Sectors as % of GSP, 1992

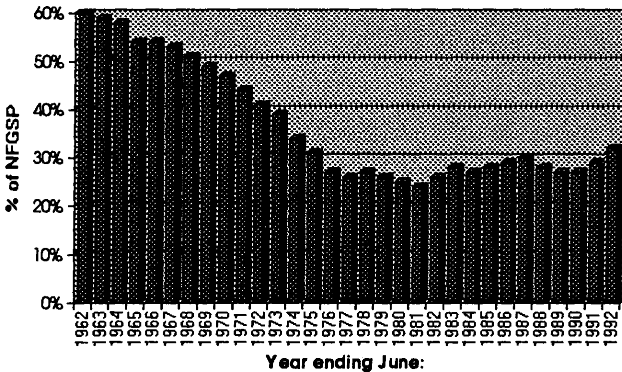


Notes: Australian Bureau of Statistics data adjusted to include debts of public trading enterprises that depend on government grants to cover large operating losses (eg. public transport).

Source: Australian Ratings/Standard and Poor's *Annual Review of the States, 1992*.

Second, by focussing on the absolute value of debt, attention is shifted away from the capacity of the State to repay the debt. The measure normally used by economists is a comparison of debt to the size of the economy (Gross Domestic or State Product). The Government does provide these data, but typically it does so by lumping together the debts of the *total* State public sector, and in a highly selective way. This is done by comparing Victoria to only two of Australia's states (New South Wales and Queensland), which happen to be the States with the lowest levels of public sector indebtedness. Figure 1 provides the more complete picture. It shows that while Victoria does have a high level of General Government debt, it does not have the highest level of debt. South Australia has the highest net debt, and Tasmania is not far behind.

Figure 2: Victorian Net Public Sector Debt, 1960/1-1982/3



Source: Victorian Treasury unpublished data, and Victorian Government *Restoring Victoria's Finances. Phase 2*, Victorian Government Printer, April 6, 1993, Table 7.3.

Historical data are also furnished on the State debt which show that since 1987/8 the total public sector debt has increased from 27.5% of GSP to 32%, from around $18b to $22b in constant 1984/5 prices. Of interest is the limited time frame chosen by the Government. It has focussed on the only period in the post war years in which public sector

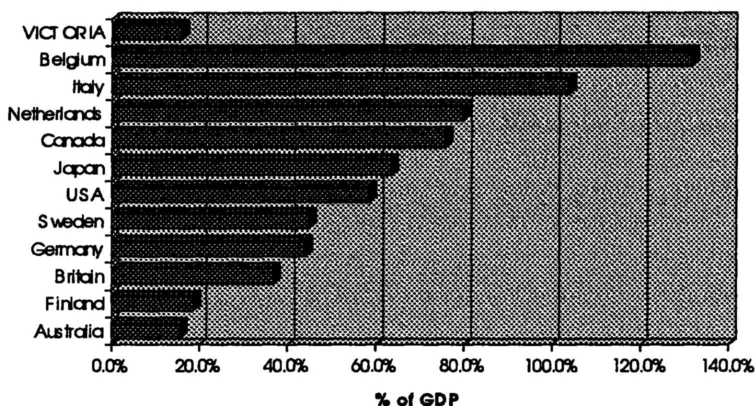
debt has risen consistently. A more balanced assessment is made possible by examining the level of net public sector debt in Victoria since 1961/2 (figure 2). The data contradict the Government's claim that Victoria is highly indebted by historical standards, and that the previous Government was a big borrowing Government. The real level of debt is about half the level it was in 1961/2. During the years of the ALP Government state debt remained roughly constant as a percentage of GSP, rising slightly during the early 1980's, falling in the latter part of the decade, then climbing at the turn of the decade when the recession caused a collapse in state revenues and spending increased in part to cover the recession induced collapse of some major financial institutions. It could hardly be said that Victoria is enduring a debt crisis.

Somewhat remarkably the Audit Commission does draw attention to these data, but it does so as a means of trying to rebut the Government's critics. It claims that it is incorrect to point to these data to show that the current level of debt is sustainable. It claims that while debt may have been higher 30 years ago, so too was capital spending, while interest rates were much lower. This means that a higher level of debt was justified then relative to the situation today (Vol. 1, 34). It also argues that the onset of a period of high interest rates during the 1980's should have been a signal for the Government to wind back the level of debt, and not increase it in the way the previous Government consciously chose to do (Vol. 1:35).

These arguments do not challenge the central point that in real terms the level of public sector debt in 1961/2 was twice today's level. It is difficult to see how this could be interpreted other than as a clear sign that much higher levels of debt can be sustained without jeopardising economic activity. Moreover, it is quite wrong to suggest that the previous Government consciously sought to increase state indebtedness throughout the 1980's. While this was certainly true during the early 1980's when the Cain Government intentionally used debt-funded spending initiatives to end the deep 1981/2 recession, during the latter half of the decade when the economy was growing strongly the objective was to wind back state debt in real terms (Victorian Government, 1988; and 1989). This is precisely what occurred. Only

with the onset of deep recession in 1990 did state debt start to increase, but this was due to factors beyond the then Government's control. Finally, while the level of capital outlays was much lower in the 1980's than in the 1960's, up until the onset of severe recession in 1990, the Government continued to finance up to one fifth of capital outlays from its current account surplus.

Figure 3: Gross General Government Sector Debt as % of GDP, Selected OECD Countries and Victoria, 1991



Source: Langmore (1993); Nicholls (1992: 117). The Victorian data used by Langmore are incorrect. He uses gross debt data for the Total State Government sector, while the international data he uses relate to the General Government sector only. The Victorian data above are taken from *The Nicholls Report*.

It could be argued that interstate and historical data on debt do not provide a complete picture. It could be that Australian Governments are highly indebted by comparison with other countries, and all Australian Governments, not just the Victorian State Government, need to address this problem. So how do Australian Governments compare internationally? This is a question that was addressed recently by the Federal ALP parliamentarian, John Langmore (1993). After presenting data that compare Australia's net public sector debt as a percent of GDP

for a selection of OECD countries, Langmore concluded that, "Australian Government debt as a proportion of our gross domestic product is...lower than in any comparable country".

Langmore's data, reproduced in Figure 3, provide unambiguous support for the view that, even by international standards, Victoria does not have a debt crisis. The international data also show that Victoria is not alone in experiencing a worsening debt situation in recent years; every country in the OECD has experienced the same outcome as a consequence of the severe global recession which has wrought havoc on budget revenues and outlays (Figure 4).

It would be reassuring to believe that the Government is simply unaware of these data. Yet in its April 6 Economic Statement the Government notes that,

> ...debts of Australian Governments are not high by international standards...(pp. 7-4).

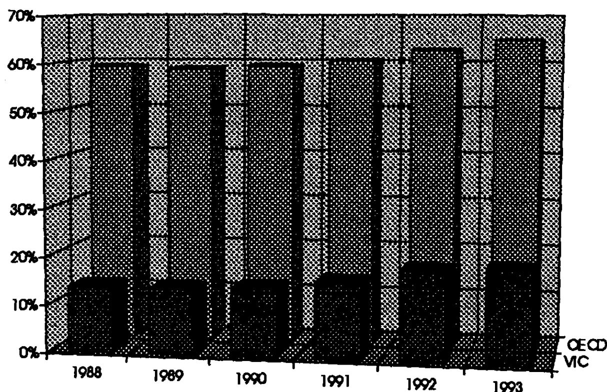
Interest Costs

The argument so far is that the Government (and the Audit Commission) has been highly selective in its use of data so as to suggest a debt "crisis", and that once a fuller picture is provided it is clear that Victoria does not have a debt crisis. In response, the Government would probably claim that the key issue is not so much the debt, but the interest burden of the debt, which takes funds away from other more noble causes (Stockdale 1993)

Within the Economic Statements there are at least three different ways in which the interest burden is measured. The first involves showing total interest payments of the public sector (the budget sector and the utilities like the SECV) as a percentage of revenues and Commonwealth current grants of the budget sector only (Victorian Government, 1993a, pp. 7-4). These data suggest that 23% of the Victorian budget is devoted toward interest payments. This measure of the interest burden is deceptive because while it *includes* the interest payments of the State's Public Trading Enterprises, it *ignores* their operating revenues

(worth about $7.5 billion), thereby inflating artificially the magnitude of the interest burden. A more accurate figure would either exclude the Public Trading Enterprise sector completely, or else would focus on interest and revenues (including PTE operating revenues) of the total public sector[1].

Figure 4: General Government Gross Debt, Victoria and OECD Average as % of GDP, 1987/8-1992/3



Source: OECD Revenue Statistics for Member Countries and Victorian Government Budget Papers.

The second measure of the interest burden overcomes the problems of the first one. This measure compares the interest paid by the budget sector as a percentage of budget sector state sourced revenues (Victorian Government, 1993a: 3-3). Using this measure, the interest burden appears to be even higher than the first measure, with interest accounting for 28.3% of budget sector state sourced revenues.

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1 I suspect that the confusion here is a product of the Government incorrectly applying the private sector notion of interest cover to the total public sector, which gives a quite misleading impression about the magnitude of an interest burden.

However, this measure is also faulty because state sourced revenues are not the only sources of current income available to the budget sector from which interest payments can be met. Overlooked is Commonwealth Government current grants (worth about $4.5 billion), which are relevant to the burden that interest payments impose on the budget.

The most accurate indicator of the interest burden is interest payments as a percentage of revenue and current grants of the budget sector. Surprisingly, these data are also provided in the Economic Statements, and are reproduced in Table 2 (the non-italicised numbers). These data show that the interest burden is far lower than the Government implies in much of its commentary, with budget sector interest payments accounting for 17% of total current budget sector revenues in 1992/3.

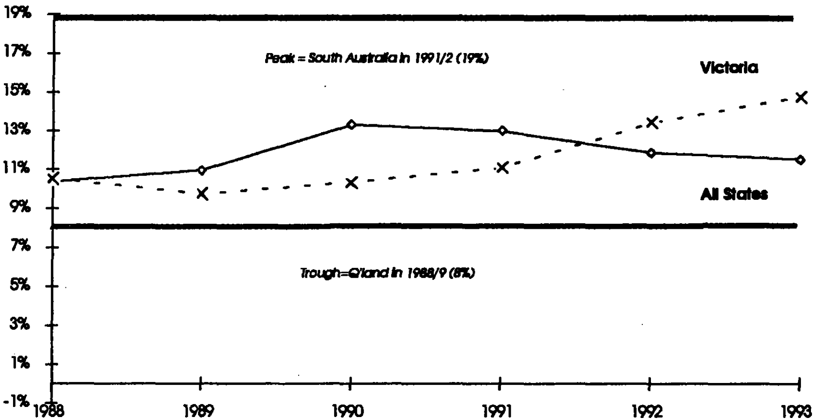
Table 2: Budget Sector Interest as a % of Budget Sector Revenues and Grants According to Table 1.1 and Table 1.2 of the April Economic Statement.

	1992/3	1993/4	1994/5	1995/6
Interest Paid According to Table 1.2 and Table 7.3 (With Economic Statement's redundancy program)	$1,942	$2,096	$2,289	$2,344
Revenue and Grants According to Table 1.2	$11,328	$12,119	$12,536	$12,862
Interest As % of Revenue and Current Grants According to Table 1.2 and Table 7.3	17.1%	17.3%	18.3%	18.2%
Interest Paid According to Table 1.1. (Without April Statement's Redundancy Program)	*$1,942*	*$2,045*	*$2,207*	*$2,273*
Revenue and Grants According to Table 1.1	*$11,328*	*$12,106*	*$12,523*	*$12,854*
Interest As % of Revenue and Current Grants	*17.1%*	*16.9%*	*17.6%*	*17.7%*

Despite all this, most of the measures of the interest burden show that interest payments have come to account for a larger slice of the budget in recent years. While this could indeed be seen to be a problem, the

rate of increase in interest payments could hardly be described as being indicative of a crisis. First, interest payments in real terms remained relatively constant until 1990/91, averaging around 1.3%-1.4% of Gross State Product. It was not until the early 1990's, when interest rates rose to record high levels and the economy went into a severe recession, that interest costs began to increase significantly in real terms. Indeed, once a broader time period is chosen, it is clear that Victoria's interest burden is not that problematic in relation to the situation faced by other states in recent years (Figure 5).

Figure 5: Interest as % of General Government Revenues, Victoria and All State Average, 1987/8-1992/3



Source: ABS Cat. No. 5512.0.

Second, even allowing for the recent increase in Victoria's interest burden the Government's own projections in the Economic Statements show that interest payments as a proportion of total current budget sector revenues will only increase from 17.1% in 1992/3 to 18.2% by 1995/6. Moreover, much of this increase is largely a result not of the existing stock of debt, but new debt issued by the Government to fund the $1.2b public sector redundancy program announced in the April statement! If these increased borrowings are put to one side, interest

payments would have increased from 17.1% to only 17.7% during the four year period under consideration (Table 2).

Would it not be better for the Government to wind back the interest burden so that more funds are freed for other purposes in the longer term? The answer depends on what the original debt was used to fund, and whether the benefits of this expenditure exceed the costs. The Government itself admits that it is quite legitimate for Governments to borrow for capital purposes, and it intends to do so in the future (Victorian Government, 1993a: 6-1). Ultimately, the question is whether the interest payments are for debt incurred to finance capital or current spending. The answer is unambiguous. Excluding the 1992/3 budget, there have been only three occasions in Victoria's post-war history when Governments have borrowed to fund current spending: these were the last three ALP budgets, when a severe economic downturn sent state revenues into a tailspin and brought forth additional expenditure commitments. The accumulated debt of these current account deficits account for only $1.2b of Victoria's current budget sector debt of $19.2 b, and the interest burden of this debt is likely to be only $100m-$120m annually, which is equivalent to only around 6% of the Government's interest bill.

The Current Account Deficit

This raises the third argument proffered by the Government (and the Audit Commission) in favour of its budgetary approach: the budget's current account deficit (CAD){see pages 52 and 53}. Here the Government is on stronger ground. It is generally agreed by economists that a CAD is bad, and that governments are financially unwise to run a CAD over the longer term (Heilbroner and Bernstein, 1989; Musgrave and Musgrave, 1980). Economists also recognise, though, that government budgets have a strong cyclical element. When the economy is booming, revenues surge and expenditure demands contract, while the opposite is true during recessions. As a consequence when an economy moves from a boom to recession, the budgetary position will deteriorate as a consequence of changed economic conditions. From an economic standpoint this is the important 'counter-

cyclical' role that budgets should play, with increased government spending (and deficits) helping to lessen what would otherwise be a more severe recession (OECD, 1993).

How does all this relate to the Victorian Government? Victoria has endured its most severe recession in 60 years, as the Government itself admits, and one that has been much worse than that experienced by the rest of Australia. According to the April Economic Statement, "in the two years to 1992/3, Victoria's GDP fell by 5.5% while GDP for the rest of Australia increased by 1%" (p. 2-2). This more severe recession in Victoria largely accounts for the emergence of the CAD in 1989/90, and its persistence during the early 1990's. During this time revenues fell away and outlays (as a result largely of the financial failures arising from the recession) increased to levels that understandably were not anticipated by the then Labor Governments at the time the budgets were framed.

Given the severely recessed state of the Victorian economy, the existence of the CAD should not be of great concern, for once the economy improves the budget deficit could be expected largely to disappear. An accurate assessment of the economic cycle on budget deficits requires a distinction between those aspects of a deficit that are recession induced, and those that are a product of the government's policy commitments (the structural component). The Commonwealth Government does this every year in its budget papers, and a paper was prepared for the 1993 Premiers Conference which tried to do this for the total public sector (National Fiscal Outlook, 1993). In its most recent budget, the Kennett Government acknowledges the importance of this distinction between cyclical and structural deficits (Victorian Government, 1993b: page 3-4), but it has made no serious attempt to estimate the size of the structural deficit. Rather, its budgetary strategy continues to be framed on the assumption that the deficit is structural in nature.

It might be that the Government is simply very pessimistic about the Victorian economy, and as a result is concerned about the State's tax base. For example, it might be argued that Victoria's economic woes are rooted in the state's manufacturing base, which has been chronically and permanently damaged by tariff cuts. This hole in the economy

translates into a structural weakness in the tax base. If this were the case, it might take decades, not years for this problem to be resolved, so the Government has little choice but to try to balance the books immediately.

Interestingly, the Kennett Government does not argue this way. It argues that the state's tax base has been weakened, but not by industrial decline. Rather, it is the rapid growth in small firms, which are exempt from payroll tax (Victorian Government, 1993b:3-4). This is unlikely to account for all the current account deficit, and the simple solution to this would be to close this tax loophole. How does the Government explain Victoria's economic problems? Its view is set out very clearly in the first Economic Statement:

> A more severe downturn in private sector spending in Victoria was the main factor in the deep recession in this State...The main reason for this fall in private sector spending in Victoria relative to the rest of Australia, was the *collapse in confidence which followed the failures of Tricontinental and the Farrow Group of Building Societies* (Victorian Government, 1992: 2. Emphasis added).

In short, the severe recession in Victoria is primarily cyclical rather than structural, involving a collapse in confidence engendered by a short sharp bout of major financial failures.

If this is the case, it is difficult to see how the Government's economic strategy will have anything other than a detrimental impact on the economic recovery. By cutting spending and increasing taxes so severely, the Government's actions are likely to exacerbate the economic downturn (cuts in spending will tend to reduce economic growth, as will increases in taxes), making it even more difficult for the Government to balance its books. Furthermore, much of what the Government has said since coming to office is negative in tone. The Premier recently described Victoria's financial problems in this way:

> We are not dealing with something which can be solved in a year. This is something that is going to take us forever. Forever...(The Government) is trying to keep increases (in taxes and charges) down to a minimum...But the Board of Works situation; super; they're all absolutely RS...This super thing is bigger than 'Ben Hur' - it is huge, it's massive...(The public) are owed the facts and by hell they're going to get 'em" (quoted in *The Age*, March 30, 1993:1).

A savagely deflationary budget in combination with a negative economic outlook by the State Government are likely to deepen the recession and lower the confidence of businesses and consumers alike. Remarkably, the Government seems to recognise this. In its April Economic Statement the Government has down graded Victoria's growth forecasts from 2.5% to 2.3% for 1992/3, and from 3% to 2.5% for the next couple of years, which means that revenue growth will be lower than it otherwise would be (p. 2-2). One of the reasons offered by the Government for this reduction in the growth forecasts is the effect of "lower growth in Government spending in Victoria than in some other states" (pp. 1-3).

The Audit Commission Reconsidered

Like the State Government, the Audit Commission can also be criticised for using its data in highly selective and misleading ways. Prior to the Audit Commission, the Government estimated Victoria's debt at $32b, but now it is happier to refer to the Audit Commission's estimate of the State's liabilities of $70b. The Audit Commission uses "a whole of government" approach to public finances, in which all the liabilities of every part of the public sector are examined. Included in the Audit Commission's $70b estimate are not only the State debt, but also all unfunded superannuation liabilities, operating lease agreements, and the liabilities of State financial institutions. This is a contentious procedure because it lumps together liabilities of quite different organisations and enterprises. The liabilities of the profitable PTEs, for example, are treated as being identical to those of government departments. It also includes questionable interpretations of what represents a liability (notably in the case of operating leases). In addition, the Commission conveniently fails to deduct liquid financial assets from gross liabilities to give a net debt figure. Further, whereas the Commission goes to great lengths to estimate and include such contentious liabilities in its estimate for Victoria, it fails to do likewise for the other States, choosing instead to make interstate comparisons using the widely used and accepted Australian Bureau of Statistics' data (Walker, 1993a; 1993b; and 1993c). When stripped of the

problematical inclusions, the Audit Commission's data show that budget sector debt in Victoria is approximately $19b, basically the same as was estimated prior to the Commission bringing down its findings.

In addition to the questionable way it estimates the State debt situation, the Commission also presents data which sharply contradict its own conclusions. Although it criticises the previous Government for allowing the current account deficit to emerge, the Commission simultaneously acknowledges that this was not a product of conscious Government policy, but the onset of severe recession, which was not foreseen by any of the nation's economic forecasters, including those in the Victorian Treasury. The Commission draws attention to the discrepancies between Victorian Treasury forecasts (only one of which tipped a current account deficit arising) and the actual outcomes, and in the process correctly alludes to the unintentional way that the deficit arose (Vol. 1:49,57). "The economic downturn", the Commission correctly points out, "has undeniably hampered [the Victorian Government's] ability to generate current surpluses (both absolutely and compared with other states)" (Vol. 1:77).

Despite its frequent claims that Victoria is weighed down by a bloated public sector, the Commission also acknowledges that the available ABS data point to a different picture: "Victorian General Government outlays are lower as a proportion of GSP than in any other State" (Vol. 1:80) (Table 3). It also recognises that the same ABS data show that the previous Government did not unleash a wave of spending commitments, but actually kept a tight lid on Government spending, with the "growth in Victorian General Government outlays in recent years [being] more restrained in Victoria than in most other states" (Vol. 1:80). The Commission accepts that these ABS data show that this restraint has not just been restricted to the capital budget, for "between 1984/5 and 1991/2 real per capita current outlays rose (in Victoria) at an average annual rate of 1.7% (1% excluding interest) compared with an average (for all states) of 1.9% (1.7% excluding interest)" (Vol. 1, 82). The Commission also points to the role that Commonwealth cutbacks played in exacerbating Victoria's financial situation, as well as the revenue damage caused by John Cain's "family pledge" in 1988 not to increase a basket of taxes and charges even in

nominal terms. It is largely because of the latter that the Commission actually finds, "Victoria's tax burden...(to have been) almost 10% lower than that of NSW over the last 3 years" (Vol. 1:89).

Table 3: Outlays and Revenues of State General Government Sectors (average for 1989/90-1991/2) as % of GSP

	NSW	*Vic.*	Q'land	SA	WA	Tas.
Current Outlays	13.0	*12.1*	12.5	16.9	13.5	20
Capital Outlays	2.1	*1.3*	2.5	2.1	2.1	2.8
Total Outlays	15.1	*13.4*	15.0	19.0	15.6	22.9
Total Revenues	14.5	*12.4*	16.0	18.0	14.9	22.2
Of Which						
• Taxes, fees, fines	6.4	*5.7*	5.0	5.4	5.0	6.3
• Other own source	3.0	*1.4*	3.9	4.4	3.5	4.9
• C'wealth Grants	5.1	*5.0*	7.1	8.2	6.4	11.0

Source: Victorian Commission of Audit, 1993: Tables 3.2 and 3.4

What accounts for these discrepancies in the Commission's position? How can it argue on the one hand that Victoria's budgetary problems are caused by excessive growth in government spending rather than too little tax, yet present data that show the opposite to be true? The answer is to be found in the curious way the Commission uses the available data. In assessing the relative size of public sectors and their growth, economists normally compare outlays and revenues as a percent of GDP. When the Commission uses these data it finds that Victoria has one of the smallest public sectors in Australia, and that it has practiced commendable expenditure restraint despite very difficult economic conditions.

These are not the only data that are available. The Commonwealth Grants Commission also collects data on state budgets, which it uses in its fiscal equalisation formula to recommend how to distribute financial assistance grants between the states. These data are compiled and analysed using a complex formula, which does not take account of all forms of spending nor all forms of taxing. Moreover, it makes a variety of value judgements concerning the relative importance of different expenditure items, and employs various weighting procedures that are

subject to considerable debate and controversy. Each year the Commission is severely criticised by a number of States precisely because of the questionable way in which it calculates its data. Particularly damning of this method and the formulae which underpins it are New South Wales and Victoria, which each year maintain that it results in them having to subsidise the smaller States to the tune of hundreds of millions of dollars. Perhaps the best demolition of the Grants Commission formulae is to be found in the Victorian Government's 1992/3 budget papers (Paper No. 6), which were extremely strong in their condemnation of the Grants Commission figures[2].

Yet it is these Grants Commission data which the Audit Commission depends upon to conclude that Victoria overspends relative to the other states, and it is on the basis of these data that the Audit Commission commends the Government for cutting Government spending. It will be interesting to see at the next Premiers' Conference whether any of the smaller states are clever enough to point out to Premier Kennett and Treasurer Stockdale that it is only on the basis of the Grants Commission data that their harsh budgetary strategy can be justified!

There is one other serious problem with the way that the Audit Commission has analysed the available data. In order to estimate the viability of the last Kirner budget, the Commission hired Access Economics to construct a model which would show what the budget outcome would have been had this budget not been replaced by the Government's two Economic Statements. The "key indicator" parts of this Table is reproduced in Table 4. The Commission claims that these

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2 Remarkably, the Audit Commission is aware that the Grants Commission data are problematic. It comments that, "The Commission acknowledges that these (the Victorian Treasury's) criticisms have some merit. However, as one would logically expect NSW to be similarly affected to Victoria, in most respects by such deficiencies, one might therefore expect the CGC analysis to indicate some degree of 'overspending' by NSW relative to assessed needs. Since it does not, the Commission concludes that the Victorian Treasury's criticism do not invalidate the conclusion that Victoria's spending exceeds that required to provide the same level of services as in other states, although it accepts that the margin of overspending may not be as large as suggested by the CGC" (Vol 1, 87). Having said all this the Commission then proceeds to use the CGC data as if they were unproblematic.

data provide unambiguous support for the Government's harsh budgetary medicine, confirming that the last Kirner budget was unsustainable in that it was leading Victoria into a debt trap.

Table 4: Outlook for Victorian Public Sector Finances Assuming Unchanged Policies from August 1992 Budget

Key Ratios	1992/3	1993/4	1994/5	1995/6	1996/7
Operating balance to current revenues (%)	-9.8	-14.0	-13.8	-12.9	-12.6
Net interest payments to own source revenues (%)	*37.6*	*37.1*	*37.2*	*35.6*	*34.2*
Interest cover (times)	-0.4	-0.6	-0.6	-0.6	-0.6
Deficit to total revenue (%)	5.3	12.6	13.9	15.8	18.4
Net debt to total revenue (%)	198.0	208.0	208.0	210.0	216.0
Net Debt to GSP (%)	*32.0*	*31.6*	*31.3*	*31.2*	*31.7*

Source: Victorian Commission of Audit, 1993: 128

The data, however, do not show this at all. What they show is that net debt as a percentage of GSP would have *declined*, and not increased, falling from 32% of GSP in 1992/3 to 31.7% by 1996/7. Nor do the data show that the State was heading for an interest trap. Net interest payments as a percentage of own source revenues would have fallen from 37.6% in 1992/3 to 34.2% by 1996/7. Moreover, the Access Economics model seems to have been constructed using "pessimistic" assumptions: very modest economic growth of 3% per annum, a credit rating downgrade pushing interest costs up, an increase in capital outlays from 1.3% of GSP to 2.7% by 1996/7, declining Commonwealth Grants, and no new revenue initiatives once the recession has ended (Vol. 1:125).

The Kennett Cuts: Are they necessary?

The Kennett Government's critique of the previous Labor Government does not stand up to critical scrutiny. The Cain/Kirner Governments were not big spending, big taxing Governments, nor were they wedded

to a large public sector borrowing program. Indeed, at the conclusion of Labor's ten years in office, the Victorian public sector was one of Australia's smallest, accounting for a smaller proportion of state economic activity than any other state (Table 3), and a smaller proportion of total employment than any other state except New South Wales. The current account deficit that emerged under the Labor Government was not a product of conscious policy. It was basically caused by a major recession, the depth and duration of which was unanticipated not only by the State Treasury, but by virtually all private and public economic commentators throughout Australia. Victoria is not in the middle of a crisis in State finances. It is experiencing some budgetary problems because of a very severe cyclical downturn in the state economy, a downturn which has affected Victoria much more severely than the rest of Australia.

Moreover, the Kennett budgetary strategy is both flawed and damaging. The Government seems to have recognised that its cutbacks have lowered economic growth in Victoria, thereby worsening the recession. It also seems to have recognised that there is an urgent need to increase capital outlays. The Audit Commission pointed out that while the Government needs to spend approximately $1.3b per annum just to maintain the existing infrastructure, it is spending only about half this amount at the moment. By the year 2005, the unmet backlog of maintenance spending could be around $9b (in 1992/3 prices) (Victorian Commission of Audit , 1993:Vol. 2:268-273).

This latter point touches on the contradictory flavour of the Kennett Government's budgetary strategy. In its most recent budget (Victorian Government, 1993b), the Government acknowledges the importance of education to the State's economy, yet during the coming summer is about to close over 100 schools (in addition to the 50 that have already been closed), and retrench more teachers (in addition to the 6,000 education jobs abolished already) in order to cut education spending by a further $145m. The Government recognises that the State's unemployment level is unacceptably high, yet it is in the middle of making 44,000 public sector jobs redundant. The Government argues that the State's main problem is the level of public sector debt, but then embarks on a $2b borrowing program to finance the redundancy

payments made necessary by the public sector retrenchments. The Government says it wants to cut spending now, and spend more when the Government can afford to, even though this means worsening the current recession and may only exacerbate the next boom. The Government has been happy to run the line that it is broke, while simultaneously increasing the salaries of Government ministers and senior public servants (the latter can now earn in excess of $250,000). The Government has emphasised the dire state of Government revenues, and the problematical nature of the State tax base. Yet it continues to advocate splitting up and privatising the State's profitable utilities, which will put an end to the annual $1b revenue stream that now flows from the utilities to the budget.

It is not an economic logic that is underpinning the Kennett cuts; the very same policies have been tried and have failed in a range of countries, including the United Kingdom and New Zealand. The logic of the Kennett cuts is a political one. It involves four steps. First, enter an election campaign against an unpopular, long-standing Government, using a set of "false" policies, which are vague and generally inoffensive. Second, once the election is over manufacture a crisis atmosphere around government finances, drawing on themes that have been promoted by the media and various neo-conservative commentators in previous years, and which are implicitly endorsed by the outgoing administration. Third give the impression that these financial problems are so pressing that the Government's election commitments cannot be met. Fourth, establish a Commission consisting of people who are sympathetic to the Government's position, and then use the Commission's findings to defend the Government's strategy. Finally, embark on a savage cost cutting program that will enable the "manufactured financial problem" to be resolved prior to the next election, and use this "financial success story" as a basis for the next election campaign.

Is this strategy likely to succeed? The latest opinion poll results show that almost all Victorians believe that the Government inherrited an economic mess, and that while the cuts may have gone too far the Government is viewed positively, particularly by men, for tackling such a difficult problem. The Government's level of support has risen from

42% in March 1993 to 54% by the end of September. Support for the Labor Party, on the other hand, has plumetted to 29% (*The Age*, 2 October, 1993).

In using this particular political strategy, the Kennett Government is following a path already taken by Premier Greiner in New South Wales and Premier Groom in Tasmania. It is a path that Premier Court in Western Australia is about to follow, and which is likely also to be followed by Opposition Leader Brown should he win the forthcoming South Australian state election. In short, the Kennett cuts are not necessary economically. But they are necessary politically. They form part of what Noam Chomsky might call "the necessary illusions" of contemporary Australian State politics.

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