Australia’s deficits

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The railway connecting Sydney to Melbourne crosses the Murrumbidgee at Wagga on a bridge built in the 1880s. To negotiate the crossing trains are reduced to a speed limit of 20 km an hour. Closer to Sydney, on the same line, is the 1863 Menangle Bridge, which was recently out of action for four weeks.

Similar examples abound; the first bridge out of the ACT on the line to Sydney is a 90 year old wooden structure. Many of Australia’s railroads have ancient bridges, primitive traffic control systems, dangerous level crossings with roads, steep gradients, weak foundations and tight curves. In many cases speed and load restrictions are more severe than they were in the age of steam. Of all the main intercapital railroads in Australia, only the Adelaide to Perth line is of adequate quality, able to take double-stacked containers at a reasonable speed.

Forty kilometres to the east of Wagga is the main road linking Sydney and Melbourne, the Hume Highway. Although at both the Sydney and Melbourne end it is worthy of the name “highway”, with four lanes and grade separation, in the middle there is a 160 km stretch of narrow two lane road, a lethal memorial of the Commonwealth’s abandonment of its commitment to fund the national highway system. Of all Australia’s capital cities, only two – Canberra and Sydney – are connected by a highway.

At least they paid for the sign

When, in 2002 the Commonwealth’s own research (‘Auslink’) identified shortfalls in highway funding, the Commonwealth’s response was to reduce further funding for the national highway system. From 1999 to 2002 total public investment in roads fell from 0.70 percent of GDP to 0.55 percent of GDP – an annual fall of around $2.7 billion.[1]

The Institution of Engineers estimates conservatively that the deficit in Australia’s intercapital surface transport is $20 billion – being $17 for national highways and $3 billion for rail track.[2] And that does not include costs within our cities.

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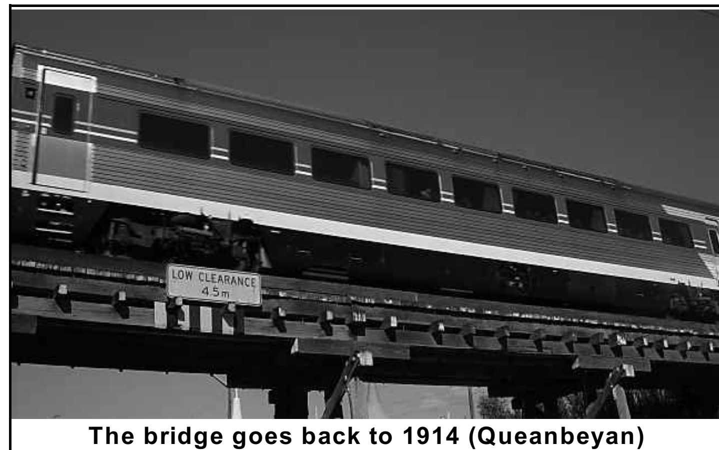
1. Derived from ABS *Engineering Construction Activity* Cat 8762.0 and GDP figures. Includes “bridges”.

2. Institution of Engineers 2001.

In Australia’s traffic-choked cities, the costs of urban road congestion are estimated at $13 billion a year.[3] The Sydney urban rail system is struggling with its load, transport economists estimate that it needs a capital injection of $20 million to bring it to a reasonable standard. Road and public transport lobbyists fight over paltry allocations for transport, which are absorbed in a few highly visible road projects and cosmetic public transport projects, such as new rolling stock on ancient lines.



The bridge goes back to 1914 (Queanbeyan)

Australia’s railroads and roads may have trouble coping with our transport tasks, but our rivers are carrying a gargantuan load. Every day the equivalent of 1000 truckloads of salt are conveyed down the River Murray and salt levels are rising throughout the Murray-Darling Basin; the CSIRO estimates that the salinity of Adelaide’s water will rise to exceed WHO guidelines for drinking water in the near future. A report commissioned by the Australian Conservation Foundation and the NSW Farmers’ Federation has estimated that $65 billion is required to arrest environmental degradation in Australia.[4]

These deficits in our infrastructure – mainly our transport and environmental infrastructure – get little attention from politicians. Rather, when infrastructure deficits are pointed out, they talk vacuously about the need for more private sector investment, before drawing our attention to a more narrowly-construed deficit – the financial figure known as “public debt”.

Public debt

Peter Costello, in bringing down the annual Commonwealth Budget, gloats about Australia’s low level of public debt. Since coming to office in 1996, the Coalition Government has reduced officially recorded government debt, from 19 percent of GDP in 1995-96 to a budgeted 4 percent of GDP in 2003-04, and budget projections suggest net Commonwealth debt will be eliminated by 2006-07. This compares with a current average public debt of 50 to 60 percent of GDP in other OECD countries.

But how can the Commonwealth Treasurer (or for that matter his state counterparts) talk about our being free of debt, when it’s reasonably clear that we are facing huge future expenditures to restore the quality and productivity of our human-made and natural infrastructure?

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3. Institution of Engineers 1999.

4. John Harris 2001.

The answer lies, in large part, by what is meant by the word "debt", or "liability" in accounting terms.

Malcolm Fraser, when he was Prime Minister, was given to using household metaphors to explain economic concepts. A household metaphor may help us understand why the financial accounting concepts used by the Commonwealth do not align with our commonsense concepts of debt.

We can imagine a scrooge who lives his life to impress his bank manager. He pays off his mortgage as quickly as possible – a reasonable investment in the case of Australia's tax laws. But he stays in the habit of saving money. When the roof of his house springs a leak, he does not call a plumber; rather he puts a bucket under the drip while water stains slowly ruin the plasterboard and carpet. He is reluctant to replace his 20 year old car; he goes on paying higher and higher repair bills to keep it on the road. His yard becomes overgrown with weeds, and the local government sends him cleanup notices, which he ignores, but he knows he will have to pay for a contractor some day in the future, and the longer he leaves it the more it will cost.

Now by any commonsense notion we would say he is incurring liabilities. But that is not the way his bank manager would see it, aware only of his healthy bank account, and would undoubtedly give him an AAA credit rating on the basis of his financial prudence.

In a financial accounting sense a liability is defined as such only if it relates to an obligation to which one is already contractually committed. The Commonwealth has a contractual obligation to pay holders of Commonwealth bonds, but it has no written contractual obligation to clean up the Murray Darling Basin, or to finish construction of the Hume Highway.

It is through the use of such a narrow definition of a "liability" that the Commonwealth can boast that it is reducing public debt, while, by any commonsense notion, it is abrogating its responsibility to sustain the community's shared assets – the common wealth. This narrow definition may be fine for an individual or a company; a private corporation is at liberty to dispose of its assets, or even to let certain assets run down. But the relationship between shareholders and a corporation can be defined largely in narrow financial terms; that is not the relationship a community seeks with its governments.

Selling the family silver

A related phenomenon is privatization. The four main asset sales of the 1990s – the Commonwealth Bank, Qantas, the Commonwealth Serum Laboratory and half of Telstra – swelled the Commonwealth's coffers by $40 billion.

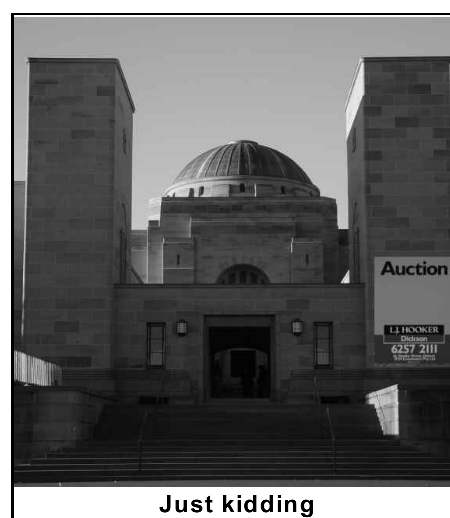
It is notable that this big swag of privatizations was completed by 1999, because the 1999-2000 was the first budget to include a set of statements in accrual terms. Until then, all statements had been in cash terms. Under cash accounting receipt from an asset sale is counted (erroneously) as "revenue". Under accrual accounting sale of a capital item is treated as an asset swap with no net change in the entity's wealth. The receipt of cash is a debit, balanced by an equal credit on the capital account.

Cash accounting fosters the illusion that one can live of the proceeds from selling the family silver; accrual accounting helps overcome this illusion. It was therefore very convenient for the Commonwealth to delay introduction of accrual accounting until 1999, when there was not much of the family silver left to sell.

Of course the Commonwealth can explain the delay. It claims that it is difficult to transfer accrual concepts, developed in the business sector, to the public sector; that's why it took so long.

It is indeed been difficult, and the Commonwealth is still struggling with the process; it maintains two sets of accounts, one in accordance with international standards set by the IMF, and another home-grown set. Both have their shortcomings.

In particular asset valuation is extremely difficult when it comes to infrastructure, defence and heritage assets. What is the value of Kakadu National Park, an F111 fighter, the National War Memorial? Who actually owns these assets – is the Commonwealth the owner with rights to dispose of them, or is it a custodian with a responsibility to maintain them? Is it meaningful to apply measures such as depreciation to these assets?



Just kidding

These are not just arcane technical accounting questions; they go to the heart of the relation between a community and its governments. If the government is just another business, then it is reasonable that it should use standard business accounting practices. But government is not, or should not be, "just another business".

In a business, assets are generally valued at the cost of acquisition, with allowance for revaluation of long-life assets, such as land, at market price. In the public sector this practice can be applied to administrative assets, such as computers and motor vehicles. But for the important assets in the public sector, particularly infrastructure assets, such valuation practices are meaningless.

In a business assets are held because they bring benefits to the business. In government, by contrast, assets are held because they bring benefits to the public. In general, governments do not invest in assets unless the benefits, usually benefits to the public, outweigh the costs; that is the basis of cost-benefit analysis. Transport infrastructure, for example, generally has a ratio of costs to benefits of around 2:1. A road or railroad costing one billion dollars should have a public benefit of around two billion dollars.

Furthermore, many infrastructure assets have very long lives, such as the 120 year old rail bridge at Wagga; historical valuations are therefore often meaningless. And, while the private sector may be able to obtain market valuations, there is no market for most infrastructure and heritage assets. Who would want to buy the Sturt Highway or the Wagga rail bridge? And while governments may be the nominal owners of these assets, they do not enjoy unfettered rights of disposal enjoyed by businesses in the private sector; imagine the

wrath of the RSL if the Commonwealth tried to sell the National War Memorial to the Mitsui Corporation.

These reservations, however, do not excuse the Commonwealth from its cynical manipulation of the timing of introduction of accrual accounting.

After all, accrual accounting is hardly a novelty (although some of the government's propaganda would lead one to believe it was invented in the Department of Finance and Administration in the late 1990s). Double entry bookkeeping and accrual accounting were in use in the merchant ports of Venice and Genoa in the sixteenth century, perhaps earlier. As long ago as 1976 the Royal Commission on Australian Government Administration recommended that the Commonwealth adopt accrual accounting. Even if it was difficult to develop comprehensive standards, the least the Keating Government could have done before embarking on its auction of public assets would have been to develop accrual standards for asset sales.

Giving away the family silver

The problems of privatization are not confined to accountability. In most cases governments have sold assets well below their market value. When our indigent relative sells the family silver to pay his bills at the liquor store, the least we can hope for is that he gets a fair price.

But looking at the same set of four big Commonwealth asset sales mentioned above, University of New South Wales academics Bob and Betty Walker have calculated that the private sector by 1999 had made a profit of $44 billion, or more than 100 percent, from these privatizations.[5] In other words there has been a net gift to the private sector of $44 billion of the nation's common wealth. This does not include the huge fees involved in underwriting the privatizations.

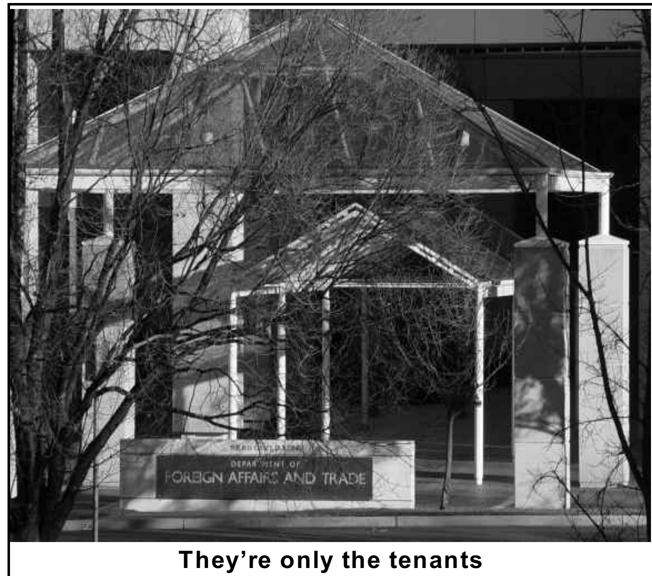
It appears that the Commonwealth used under-valuation as an attempt to popularize privatization. People were very happy with the initial capital gains they made on shares in privatized government entities.

A more pervasive factor driving privatization, particularly the more modest privatization of administrative assets such as buildings, has been an over-statement of the cost of capital, directed by the Department of Finance and Administration.

This may sound like an arcane point, but it may help, again, to use a domestic analogy. Who would consider selling their house to a landlord and then renting it back from that landlord?

The answer is that the Commonwealth would, because it vastly over-estimates the cost of having capital committed to buildings. The practice has been to sell buildings and to lease them back, generally resulting in a windfall for the new landlords. In 1996 the Commonwealth Department of Finance issued a directive requiring departments and agencies to sell their buildings unless they could obtain a notional return of 20 percent on those

5. From Walker 2001, Table 2.3.



They’re only the tenants

buildings.[6] If they could sell them and lease them back from their landlords for an annual rent of less than 20 percent of their value, then they should do so. (To continue the domestic analogy, if your house has a market value of $300 000, then by this advice you should offer to sell it and rent it back for anything up to an annual rental of $60 000, while still being responsible for all outgoings.)

Following severe criticism of this practice from the Australian National Audit Office[7], the rate was reduced, in stages, from 20 to 11 percent, and it is now entrenched as a general “capital use charge”. Assets are valued by the government (in itself a contentious process), and departments and agencies are required to include 11 percent of the cost of these assets as an expense in their accounts. If they can sell these assets, and rent them back at a lower figure, then they can make a “saving” in their appropriations.

The absurdity of this practice is evident when we consider that the Commonwealth, in the bond market, can borrow at rates well below 11 percent. Long- term (10 year) Treasury Bonds have a nominal annual yield of around 5 to 6 percent, which, after inflation, equates to around 2 to 3 percent – a difference of around 8 percent. To extend the domestic analogy, who would use credit-card finance at 15 percent if they could use a bank overdraft or mortgage redraw charging 7 percent?

In fact the domestic analogy understates the waste in the Commonwealth’s practices, because many of the buildings and other facilities are purpose-built, fitted out with special security and communications hardware for example. When the landlords come to renegotiate the leases they will be essentially in a monopoly position – but that will be past the next election and past the three year period of budget projections.

In order to produce an impressive figure on reported debt, the federal government has essentially been requiring its departments and agencies to borrow “off balance sheet”, at rates of interest up to 11 percent. Under accounting standards in the private sector, corporations are required to annotate their balance sheets to record the presence of such transactions (classified as “finance leases”), but this is one of the elements of private sector accountability the Commonwealth has not embraced.

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6. Department of Finance 1996.

7. ANAO 2001.

The origins of policy

It is easy to provide simple explanations for such policies, such as "ideology", "crony capitalism", or "economic rationalism". But these are inadequate. The accusation of "economic rationalism" is particularly inappropriate, because these practices are anything but rational by any conventional economic framework.

Perhaps there is no one explanation; there are several possible candidates.

Smaller government

The first is a cult-like obsession with reducing the size of government, as an end in its own right. This obsession can be traced, in large part, to the ideologies of influential economists of the "Chicago School", such as Milton Friedman, Friedrich von Hayek and James Buchanan, embodied in what has come to be known as "public choice theory". This theory was embraced enthusiastically by the Reagan and Thatcher Governments, and by the bureaucratic elites in Canberra.

Its basis is to treat the political arena as a "market", applying the untested assumptions of market economics to the political arena. There is an insatiable demand for the services of government, particularly when these are free. The public always wants more roads, more hospital beds, more generously-funded public education. And there is always a supply of politicians and public servants willing to provide them, particularly when they can use deficit financing to escape the embarrassment of raising taxes. Ipso facto, these supply and demand pressures result in a wasteful over-supply of public goods.

Public choice theory does not discriminate between different types of public expenditure. From the comfort of their university and public service offices, economists and bureaucrats don't care to distinguish between expenditure on welfare, defence, education or infrastructure. It all represents extravagance – a diversion of resources from private markets, where efficiency can be assured through the discipline of price signals.

It's a flawed theory. There is no empirical evidence that countries with smaller governments enjoy better economic performance, and while the argument may have some validity in relation to deficit financing, it takes a deceitful slip of logic to apply the argument to all government expenditure. Research shows that it isn't so much the *size* of government expenditure that influences a nation's economic health; rather it is the *composition* of expenditure that counts. Most empirical studies find that government investment expenditure, other than military expenditure, aids economic growth[8],[9]. On other areas of government expenditure the evidence is, at best, inconclusive.[10] Public choice theory does not get down to the hard work of looking at the composition of government expenditure; from a Canberra office it's a simple matter to consider the aggregate figures, without having to

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8. Aschaeur 1989.

9. Argimon 1995.

10. Castles and Dowrick 1988.

consider annoying details such as whether expenditure is to be on pre-schools, government advertising, industry handouts, or the replacement of rotten bridges.

Ironically, government moves to cut public expenditure deeply are often self-defeating. Anthony Giddens, surveying the trail of wreckage left by the Thatcher Government in Britain, observed that the UK Government, far from reducing the size of government, had been forced to make larger public sector outlays to finance welfare benefits to be paid to the victims of its policies.[11] One of the consequences of the application of public choice theory is that deep cuts in public expenditure create poverty and unemployment, requiring expanded welfare programs, at the expense of programs likely to strengthen economic performance.

Public choice theory overlooks the reason why governments are involved in economic activities in the first place. By traditional economic theory, governments provide where markets cannot provide, or cannot provide efficiently. Markets can provide ice creams and golf buggies, but they cannot provide clean rivers or wilderness areas. Markets can provide air travel, but they cannot provide country roads (referred to in economic terms as "non-excludable" goods). Markets are particularly poor at providing large networks, such as a national rail system – because such systems are usually not profitable until the whole network is completed. (By contrast, short- haul specific-purpose railroads, such as those used to transport minerals, are provided by the market.)

Even when markets can provide transport infrastructure, they often do it poorly, for in order to recover costs the private operators must often set a price so high that valuable infrastructure goes under-utilized. (Economists refer to this phenomenon as "deadweight loss"). Urban toll roads are a case in point, the roads remain under-utilized while drivers evade tolls by adding to congestion on other "free" roads. A 1995 Commonwealth study warned about the waste in using tolls to fund urban transport,[12] but state governments, short of capital finance and a tax base, went ahead and constructed toll roads. Governments dress up such ventures under the euphemism "public private partnerships", but in reality these are about cash-starved governments effectively borrowing to fund infrastructure from private sources, at high commercial rates, rather than using their own sources of finance at much lower rates.

In dismissing all public expenditure as wasteful, or as a residual evil, public choice theory does not apply the rigorous tests of market failure or cost-benefit analysis to public outlays. As a result, it does not discriminate between truly wasteful public expenditure and that which can be justified by economic theory. Therefore there is no inconsistency in governments engaging in pork barrel projects lacking in economic justification, while cutting expenditure on productive infrastructure investments.

Balancing the budget

The notion that governments should balance their budgets has become an axiom of public policy, as illustrated in the 2001 election, when the Labor Party tried to fit its election

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[11] Giddens 1988.

[12] EPAC 1995.

commitments within the Government's paltry projected $500 million cash surplus (the budget was already in deficit in accrual terms, but neither party mentioned that).

Sound economic management dictates that over a business cycle, the recurrent component of public budgets should be in balance. When there is a private sector downturn, the government can engage in counter-cyclical spending to stimulate the economy, and can withdraw when business conditions are booming. This is the essence of macroeconomic management, as advocated by Keynes and practised by most governments for the last half-century.

Also, on a government's capital account, it is fine for government to expand its investment and borrowing as the economy grows. Just as in a successful corporation both sides of its balance sheet grow over time, we would expect the government's stock of assets and of related financial liabilities to grow over time.

But Australia, in particular, has become obsessed with the notion that each year's budget must be balanced, in cash or accrual terms (choosing whichever is more useful for impression management). When we no longer have committed centralizing socialists to kick around, the next best we can do is to denounce Keynes.

This denunciation has become easy because Australia has had the good luck not to have needed a Keynesian stimulus for some time – it's twelve years since Australia last went through a recession. In fact both Labor and Coalition governments have used counter-cyclical spending in the past, and, if they can escape from their self-created simplification of the need for a balanced budget, there is no reason they should not do so again when the need arises.

Impression management

Just as large corporations such as Enron and Global Crossings, and closer to home, HIH Insurance and OneTel, have invested heavily in impression management, so too have governments.

It was a gleeful Treasurer announced in early 2003 that Standard and Poors had upgraded Australia's foreign currency credit rating, because of Australia's "strong fiscal position".[13] Standard and Poors, and the Treasurer, attributed this rating, in large part, to the Government's budgetary performance in reducing debt.

There is a confusion in such a presentation – a confusion of government debt and foreign debt. Credit agencies produce their ratings for lenders and financiers who may be exposed to foreign currency risk. Australia has a severe and growing deficit on current account – around four percent of GDP – which over the years has contributed to an accumulated net foreign debt of $354 billion, or almost six months of GDP. Australia is an "old economy", with exports still dominated by rural and mineral products. Australia does have a debt problem, and a foreign debt is much harder to shake off than government debt. Government debt is

13. "AAA again got Australia" Commonwealth Treasurer Press Release #5, 2003.

money we owe ourselves; it is in the family, while foreign debt is money we owe to the rest of the world.

At first sight it may appear to be strange that a rating agency may assign more weight to government debt than to foreign debt. But rating agencies equate government stringency to structural strength; to bankers stringency is equated to prudence. In Australia's case foreign debt is held by the private sector, not the public sector. They assume the private sector borrows for responsible purposes, unlike governments which are intrinsically profligate. Perhaps if staff from ratings agencies got up from their desks and came to Australia to look around (including a train trip from Sydney to Melbourne), they may come to a different view about Australia's structural strength.

Contribution to saving

Australia must increase its saving, or so goes the conventional wisdom. The 1993 report on National Saving stressed the need for Australia to boost its saving.[14] Businesses, governments and households should all increase their savings.

Individually, saving may be a good idea at certain times of one's life cycle. But nationally, saving, in itself, does not do anything for present or future prosperity. Saving contributes to future prosperity only when it is directed to productive investment. (Economists, at this point, may rush to point out that there is a redundancy in the previous sentence, for do not saving and investment have to equate in a closed economy? Economists should read on, for the key word is *productive*.) Much of Australia's saving over the last ten years has gone into asset price inflation, first in the stockmarket, and then, as companies have collapsed and share prices have fallen, into real estate investment, with even higher price inflation over the last two years. We have invested, but only on paper. And while we have had too much money chasing too few private assets, we have had too little money directed to potentially profitable investments in the public sector.

Australian governments, however, hold a "crowding out" notion of capital markets. That is, the notion that public investment may lock out desirable private investment. If the government makes too great a demand on capital markets they will "crowd out" capital markets. The cost of capital to the private sector will rise and desirable private sector investment will not go ahead.

Crowding out theory rests on the (usually unstated) assumption that the private sector has a huge portfolio of high return projects – projects which can provide more private and social dividends than investments in railroads, highways or environmental restoration. Australian experience over the last two years lends no support to that assumption.

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14. Fitzgerald 1993.

Bureaucratic isolation

It is possible that ministers and their public sector advisers impute far more too much meaning into their own figures. They forget that figures generated by accounting systems are only very limited representations of the systems to which they relate.

The Commonwealth, over the last fifteen years, has tended to allow *financial management* to take on the authority once granted to *economic management*. Financial management is limited, however, by the conventions of financial accounting, and it covers only those expenditures which pass through the Commonwealth's books. Economic management is concerned with all the community's resources, including particularly those resources which don't show up in dollar measures. Financial accounting standards arise from the private sector, and even within that sector there is a growing realization that they are inadequate indicators of corporate health.[15] They are far less relevant in the public sector.

James Scott, Professor of Professor of Political Science and Anthropology at Yale, describes a common bureaucratic process, whereby bureaucrats, particularly those who are remote from the entities with which they deal, forget that the figures they use are simply abstractions.[16] They forget that the systems to which these figures refer are rich and complex. That explains, perhaps, how the Treasury can publish a document such as the *Intergenerational Report*, which completely ignores real resources and non-budgetary costs. It explains how the public can be led into believing that the annual Commonwealth Budget is a major economic statement, when it is no more than a set of financial accounting figures. It may explain how Treasury Secretary Ken Henry, in a carefully considered statement a few days after the 2003 Budget, said that the only reason the Commonwealth should issue bonds was to help stabilize private financial markets. He made no mention of their traditional function of funding productive public infrastructure.[17]

Towards accountability

So long as governments (and opposition parties) confine their attention to narrowly-constructed financial accounting figures, we will probably go along with the delusion that our deficits are under control. So long as the public are gullible enough to believe that financial stringency is the same as sound economic management, we will go on accumulating these liabilities.

Keynes, in his magisterial work on economics, warned "it is not the miser who gets rich, but he who lays out his money in fruitful investment".[18] If he were to examine the Commonwealth's accounts, he would probably re-frame the Treasurer's statement on debt and point out, accurately, that Australia could Australia could afford to invest another $260

15. See, for example, Johnson and Kaplan 1987, and Kaplan and Norton 1996.

16. Scott 1998.

17. Henry 2003.

18. Quoted by the Ludwig von Mises Institute "Essays in Political Economy".

billion in productive public infrastructure, while keeping public debt below 40 percent of GDP. Australia has come to be seriously out of step with other OECD countries

What is needed is what one might call a *charter of economic honesty,* requiring the Commonwealth to produce an annual balance sheet covering the condition of Australia's common wealth. Numerical precision may be difficult, but it should be possible to put some broad estimates of value on our collective assets, and, on the liability side of the balance sheet some estimate of the cost of bringing those assets up to the sort of standard we would wish to hand on to the next generation. Those annual statements, perhaps, could be called an *intergenerational report* on the condition of the common wealth. Because of shared Commonwealth and state responsibilities for infrastructure, the report could be prepared on a whole of government basis.

They would set the conditions for development of a bond market which would allow Australian individuals and institutions to invest in infrastructure. This would be particularly suited to small investors seeking an investment instrument with low fees and secure returns. At a time when Australians are coming to learn, the hard way, that their portfolios have been over-represented by equities and property, the time may be very opportune to provide Australians with an opportunity to invest in their common wealth.

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