# Is a Budget Deficit Really Such Bad News?

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Do we need to get rid of all public debt? There's more to good economics than clearing government ledgers of debt, writes Ian McAuley.

The fuss over the flood levy has revealed the absurdity of government budgeting.

It's the absurdity of the deficit obsession, an obsession inherited from past administrations and reinforced by Tony Abbott's three word bites — "big new tax" and "stop the debt". As ANU economics professor and member of the Reserve Bank Board Warwick McKibbin has put it, "the Opposition has locked the Government into deficit reduction mode".

It's as if the capacity to clear the ledger of government debt as quickly as possible is the be all and end all of economic management.

In relation to this obsession, there are two points that need to be made.

The first, relatively minor point, is that even if the Government were to finance the estimated full $5 billion cost of reconstruction without any offsetting saving or new levy, the effect on the budget would be negligible. Over the next two financial years official projections, made before the floods, are that Commonwealth outlays will be $740 billion. The effect of another $5 billion would be to change a razor-thin surplus of $3 billion in 2013-14 into an even smaller razor-thin deficit. In any event the figures used by governments are projections; they do not and can not take into account shocks which no reasonable person could foresee.

The second, more important point, is that elimination of all debt, which seems to be our target, is plain bad economics.

Imagine if those who are so obsessed were to cast their eye over the accounts of BHP Billiton. They would note that BHP Billiton increased its debt by more than $1 billion last year. By 30 June 2010 its debt stood at $13 billion — or at 25 per cent of its revenue. As any accountant should know, including Barnaby Joyce who claims his accounting qualifications give him authority to speak on such matters, BHP Billiton's borrowings were invested in productive assets, which show up on the asset side of the balance sheet. Well-managed companies use a mixture of equity and debt finance.

The public debate, if that's what our dumbed-down political and media statements on deficits can be called, focuses entirely on the debt side of the public balance sheet, as if public assets don't count. We do not think of the other side — our shared wealth of productive assets — "hard" infrastructure such as roads and ports, and "soft" infrastructure such as public investments in an educated and healthy population. The Commonwealth does keep a sort of balance sheet tucked away at the back of Budget Paper 1 but its valuations are absurdly conservative: the total book value of the Commonwealth's non-financial assets are only $104 billion — a paltry $4700 a head. Most outlays, even if they are capital in nature, do not make it onto the balance sheet. It's just not a focus of media or political attention.

If we are to engage in the economic debate grown-ups should be having, we need to be looking not just at debt but also what that debt is being used for. A shift in focus would lead to a very different political debate.

For a start, the Commonwealth would stop congratulating itself on having such low debt. As they keep reminding us, our net public debt is projected to peak at 6.4 per cent of GDP before falling, when most other developed countries have debt between 40 and 120 per cent of GDP, with no prospect of any reduction in the medium term.

A mature debate would have us talking about our missed opportunities to have invested in infrastructure. Opposition politicians would be criticising the government for not borrowing to fill our infrastructure gaps, just as shareholders in a public company would rightly criticise management for over-reliance on equity capital.

We would be making more sensible international comparisons. We might ask why Germany, with public debt at 40 per cent of GDP, is considered to be such a well-managed economy. The answer, of course, lies in the uses of that debt. It has excellent transport infrastructure, high public investment in human capital (particularly trade skills), and investments in technologies to cope with a world with a high price on carbon. To make a comparison, we could have another $500 billion of flood repair, environmental protection, transport infrastructure and skills upgrading, without exceeding Germany's debt.

In case this reads like a call for a spending spree, it's really a conservative call, because a balance sheet way of thinking ensures that debt is directed at productive purposes, rather than current consumption or tax cuts. The problem in countries such as Greece and Ireland is not so much their level of debt, as the fact that they have nothing to show for it.

Of course, governments have to manage overall demand lest they overheat the economy, but with households becoming more cautious by increasing their savings, the risk of overheating the economy through a higher deficit seems to be subdued for the present. The only problem right now is that many of the engineering assets needed for flood repair are in high demand by the mining sector; it may be a good time therefore for the government to re-assert the need for a 40 per cent resource rent tax to slow down the mining boom. But we should not use the floods as an excuse to stop public investment.

In the arguments about financing flood repair, most calls, particularly from the Opposition, have been to cut other investments — the National Broadband Network, health clinics and the Productivity Placement Program. By contrast, expenditure on middle-class welfare, such as the $4 billion rebate for private health insurance, remains sacred territory. Diverting expenditure from consumption to investment is almost always sound but politically difficult economic policy.

It is not surprising that state premiers are rightly concerned that the Commonwealth intends to finance much of the repair bill by deferring other infrastructure. (The debt obsession, fortunately, does not seem to have affected Coalition premiers, who have the task of economic management and who cannot earn a living by chanting three word slogans.)

The Government's decisions to take the axe to some carbon abatement schemes is defensible, however. "Cash for clunkers" was an absurdly expensive way to finance $CO_2$ reductions, costing in the order of $400 a tonne of $CO_2$ saved. And by now, domestic investments in solar panels hardly need a subsidy to be viable. A universal carbon price is far fairer and more effective, and the sacrifice of these subsidies might help us get such a price.

If we were to think in terms of a national balance sheet, we would have realised, even before the floodwaters receded, that our public balance sheet needs to be written down to account for the damage, and that we need to replace those assets. We would not be fazed by a little debt on our books, because that debt has already been incurred. Tony Windsor's national disaster fund would look more appealing (although someone as politically sharp as Windsor would know the risks of providing a government with a pot of unappropriated money). And we would not be applying a tokenistic levy which is more about the government wanting to be seen to doing something rather than attending to our most serious deficits — our shortfalls in the infrastructure needed in an economy competing in a world of high-priced carbon and eventual lower prices for our mineral resources.

Just as important, the Opposition Leader and his Treasury spokesperson would have to engage in serious economic debate, for once we are thinking about the value of our infrastructure the slogan "cut the debt" starts to have the unappealing ring of "stop the investment".