BOMA 9 CUT THE DEFICIT AND THE CRAP

Tax cuts, not more than matched by expenditure cuts are not an option in Australia because of our balance of payments difficulties. These difficulties are largely caused by deficit budgeting. Both State and Commonwealth governments are to blame ('Blame' is the right word in the light of ample warning both received). Slow to learn from past errors, first the Prime Minister and now the Premier of Queensland, have focused public attention on tax rather than expenditure. This is dangerous.

Tax cuts are being presented as the principal means of providing incentive and promoting economic growth, and the need for matching (at the very least) cuts in government expenditure has been lost in the rhetoric. Lord Keynes taught us to stimulate economic activity by increasing demand---government demand, achieved by increasing government outlays, or private demand, by decreasing taxation. As there is no way the Australian economy can continue to tolerate even present demand, tax cuts must be more than matched by expenditure cuts.

Government deficits, financed by relatively easy money, spill over into higher imports and blow out the current account deficit. This is known as the twin deficits problem. Inadequate deficit reduction, will ensure continuation, probably worsening, of our trading and debt position. It is difficult to say what is 'adequate', but the risk of reducing demand too far, causing a temporary recession, should be more acceptable than the risk of not reducing demand far enough, causing a debt problem of Latin American proportions. The debt will drain the economy for decades to come.

The fact that the current account deficit continues to average nearly $1 billion per month indicates that we are still overspending. Given the depressed state of private consumer demand and investment demand, that leaves one sector, the Government sector, to blame. The net public sector borrowing requirement (as opposed to the Commonwealth budget deficit) has fallen only marginally in the past two years, and it remains at a level too high for the economy to sustain.

Public sector borrowing can be reduced in two ways: increasing taxes or cutting expenditure. It is true that decreased tax rates will encourage more effort and this in turn eventually will increase the tax base---perhaps sufficiently to increase the total tax take. This is the famous (or infamous) Laffer curve effect on which Reaganomics relied too heavily contributing to that country's deficits blowout.

If not matched by expenditure cuts, tax cuts increase demand. The additional demand, unless completely matched by greater effort and hence domestic supply, will encourage imports, discourage exports and raise costs. It then becomes necessary to choke off demand with a reversal of the tax policy and/or tight money with high interest rates. Then the tax base does not grow and the deficit becomes a permanent economic feature.

Benefits accruing from a better-designed tax system should not be discounted or disparaged but have to be treated as welcome bonuses when they occur. It is not safe to pass them back to the community in anticipation, like wage rises in anticipation of the resources boom.

The second way to cut the deficit, by cutting expenditure, is almost fail-safe, as long as cuts are well-thought-out and represent real, on-going reductions and not merely programme deferrals. However it will take time, and of course, politically, it is more difficult than offering the public a fistful of dollars. There is a danger that the tax cuts would be immediate, while spending cuts would be slow, possibly diluted and postponed, and perhaps in the end would prove too difficult for the politicians---as happened in the US!

Governments face the temptation to sell off government assets in a privatisation programme and count the proceeds as reducing the deficit. I expect that by the time this is published Mr Hawke will have succumbed, as Thatcher before him, to this fiscal trick.

Government accounting is done on a cash flow basis and does not distinguish between the price received for sold-off capital and other revenue (from taxation, charges, government business activity, etc.). The proceeds reduce a government's net financial debt but there is no equivalent improvement in its net worth.

Lord Stockton (Harold Macmillan) described this use of the proceeds of privatisation to reduce the deficit as selling the family silver to pay the butler. He was right to point out that budget balance achieved that way is an accounting trick which does not solve the underlying problem of an excess of expenditure over revenue. Eventually, when there are no more assets to sell, the government must borrow or live within its revenues. Since the sale to the public does not increase total savings, the effect on investment in new capital is the same as if the deficit had been financed by government borrowing instead of asset sales. Of course there may be considerable improvement in the efficiency with which an asset such as Telecom functions.

The Australian economic situation demands a reduction in national spending. At the moment it is the private sector which is bearing the brunt of this. Higher interest rates, needed to dampen private demand and hold up the dollar, have depressed private investment spending, and disposable income has fallen. But interest rates can fall without inciting an inflationary surge and a plunge in the dollar only if the Government reduces its spending.

Expenditure cuts of $3.5 or 4 billion are required to eliminate the Commonwealth deficit, a further $7 billion is required to eliminate State and Local Government borrowing. It would be foolish to consider massive cuts in tax before these spending cuts were identified and under way.

Put another way: Tax cuts would be helpful if they were genuinely financed dollar for dollar by spending cuts but deficit cuts would be even more helpful.

If cuts in Government current expenditure could be translated into increased private savings, we would really be on the right track. On the other hand, expenditure cuts of the magnitude required must mean an increase in private expenditure on health, education, and other government services, for reasonably well-off income earners.

It is not clear what the net impact of these changes on savings would be. Much would depend on what savers expected in the way of inflation. Savings seem unlikely to increase dramatically as long as they are actively penalised by the tax system (i.e. you get taxed when income is earned, and then again when interest is earned on saved income).

Nominal wages growth is now about 7.3 per cent per annum, and the December quarter showed an increase of over 2 per cent. Real wages are falling, but it's our nominal wages growth which must conform with the rest of the world, and it isn't. Wages growth has to be kept down to around 4 per cent per annum. While tax cuts financed by the deficit might quell wage demands for a short while, the higher interest rates and inflation (after the dollar plunged because of capital flight), would soon fuel new demands. A few months down the line taxes would have to increase.

Substantial expenditure cuts, then, are needed just to stabilise our current account and permit modest increase in investment. The public sector borrowing requirement must be slashed and preferably eliminated. The necessary expenditure cuts will probably affect medium to higher income earners the most; indeed they must, if low income earners are not to be made worse off. On the positive side, a lower deficit should allow lower interest rates, and lower inflation. Massive tax cuts are not required as part of a short-to-medium-term macro-strategy; massive spending cuts are.

Cuts must be genuine, ongoing spending cuts, not deferrals and other one-off savings, and they must be calculated without reference to proceeds of privatisation.

Tax cuts are highly desirable, but they must take place only when the deficit has been cut and only on the basis of matching expenditure cuts. Reliance on Laffer-curve effects is sheer folly. A reduced deficit is in any case a cut in future taxes.