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Can Expenditure Cuts Eliminate a Budget Deficit? The Australian Experience

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Successive Australian Commonwealth Governments since the late 1970's have pursued a strategy of eliminating the fiscal deficit over time. Simply put, a fiscal deficit represents an excess of outlays over revenue, although there is some debate over exactly how to measure these magnitudes (Eisner, 1986). The Government has sought to maintain a balanced budget over the course of the business cycle, by accumulating surpluses in the growth phase to offset deficits in the recession phase (when automatic stabilizers increase outlays and revenue falls). It is acknowledged that deficits are an inevitable feature of the impact of the business cycle, but it is believed that *active* policy can minimize this by attacking deficits in the recessionary phase and accumulating surpluses in the expansionary phase. These surpluses allow the government to retire some of its old debt which will compensate for the increase in debt when the budget moves into deficit. This strategy has also been pursued by many other governments during this period, often under the pressure of international agencies such as the International Monetary Fund.

Australian Governments have focussed their efforts on eliminating deficits and accumulating surpluses by reducing outlays rather than increasing revenues; the process termed 'fiscal consolidation'. For example, the most recent *Budget Papers* (Commonwealth of Australia, 1998-99, No. 1, Statement 7) state that:

> The Government has relied predominantly on outlays restraint to achieve fiscal consolidation. This reflects the Government's view that expenditure control holds the key to achieving sustainable improvements in the fiscal position and that scope has existed for rationalising programmes and making government more efficient. The IMF and OECD have found that fiscal consolidation is more likely to be durable and encourage sustained economic growth if it is achieved through outlays restraint rather than tax increases which may discourage private sector activity and be syphoned off into higher spending.

Indeed, paradoxically, expenditure reductions have often been pursued alongside cuts in personal income and business taxation.

This paper will assess the strategy of fiscal consolidation. Can expenditure reductions achieve their stated objective of bringing about a balanced budget over the course of the business cycle?

Conventional Wisdom

The government's budget strategy follows a very simple neoclassical model. According to this conventional wisdom, an excess of government outlays over revenue 'crowds-out' private sector activity in one form or another. The usual channel through which this crowding-out is meant to occur is via a higher interest rate that lowers private investment in proportion to the size of the budget deficit. Alternatively, a budget deficit will drive up prices reducing private consumption through wealth effects. The picture is then complicated slightly by considering an external sector, where the excess of spending over revenue can induce an inflow of imports and/or foreign capital (since private borrowers are squeezed out of domestic capital markets) creating a 'twin deficits' problem.

The usual response to this perceived problem is to pursue a tight money policy on the monetary side so that the deficit does not lead to inflation, and to reduce government outlays on the fiscal side in order to eliminate the deficit and thereby take the government's 'heat' out of the economy. The following is a typical statement from the *Budget Papers* that reflects this policy position and its underlying neoclassical approach:

> In the short term, fiscal consolidation can be expected to encourage private sector aggregate demand in a number of ways. For example, a reduction in public demand (or even its credible expectation) can boost private sector confidence. To the extent that fiscal consolidation, or its expectation, leads to lower interest rates than otherwise there will also be a downward influence on the exchange rate. Lower interest rates and exchange rates will tend to boost economic growth. There may also be positive wealth effects associated with actual or expected lower interest rates and perceptions as to reduced, or at least no higher, future tax liabilities. In the short term it is possible for the positive impact on private sector aggregate demand to be more than offset by the adverse impact on aggregate demand associated with lower public demand. However, over the medium to longer term, fiscal consolidation will enhance growth prospects by reducing the call of the public sector on national saving, reducing risk premia, and thereby providing opportunities for higher private sector investment at lower interest rates.
>
> Both the IMF and OECD have recently examined this issue and report recent experiences where successful fiscal consolidations were achieved in conjunction with economic growth. The IMF notes in particular that in many cases countries have experienced strengthening economic growth both *during and following* a contractionary fiscal phase (their emphasis)(Commonwealth of Australia 1996-97).

Clearly, it is believed that the price effects flowing from reductions in the deficit will supposedly lead to the appropriate substitution of private for public activity. The possibility of a Keynesian outcome, where output adjusts to the fall in demand, is acknowledged only for the short term but even this is supposedly muted by recent empirical evidence. As the recent *Budget Papers* argue, "the move into underlying surplus in 1998-99 means that the Commonwealth will not need to draw on the available pool of private saving; it will become a net lender - adding to the pool of private savings available to fund private investment, without recourse to foreign savings" (1998-99; Paper No.1, Statement 1).

Central to this neoclassical view is, first, the (positive) correlation between budget deficits and interest rates, and second the (negative) correlation between interest rates and private investment. Both of these steps in the conventional model of macroeconomic policy have been criticized at both the theoretical and empirical level. First, they require that the economy be at or near full employment (or at its NAIRU) so that adjustment is borne by prices rather than output, an issue which has been debated at a theoretical level ever since Keynes. The assumption of full employment is certainly a proposition that is difficult to sustain for Australia over the relevant period, where measured unemployment rates have been constantly ratcheting upward to about 8%. Similarly, the capital critiques have questioned the logical argument linking interest rates inversely to the quantity of investment, while Fazzari (1993) has provided empirical evidence that there is no distinct link between the interest rate and investment. There has similarly been very little evidence linking the budget deficits of various countries to interest rates (Seccareccia and Sharpe 1994, Foster 1994, and Smithin 1994).

An Alternative View

Recent literature has concluded that the budget outcomes of various national governments are principally determined by the trade cycle and its impact on expenditure and revenue (Oxley and Martin, 1991) rather than government policy as such. While this conclusion, in so far as it goes, raises doubts about the viability of targeting a specific aggregate outcome as a policy objective, the analysis on which it is based is unsatisfying, since it treats the business cycle as an exogenous factor feeding into budget outcomes. The possibility also exists for reverse causation whereby the budget outcome affects the rate of growth of national income, so that there are feedback mechanisms between key economic variables, including the budget outcome itself. This paper will argue that these feedback mechanisms can render the initial attempts to balance the budget self-defeating.

Wray (1994), for example, has argued that the conventional *monetary* response to budget deficits is self-defeating because it ignores the possible impact that tight monetary policy has on aggregate economic activity. Once the recessionary nature of tight monetary policy is admitted into the model, the high interest rates that result from the central bank's response to a deficit will:

- directly worsen the deficit by increasing the government's interest payments; and
- indirectly worsen the deficit by lowering the growth of national income, which then reduces tax revenues and increases government outlays.

This paper complements Wray's analysis by arguing that there is also a dynamic relationship between the government's *fiscal policy* response to budget deficits and national income. There are three channels through which fiscal consolidation can adversely affect national income. The first is the traditional Keynesian multiplier whereby, in an economy not fixed at full employment, any reduction in government spending will reduce aggregate demand. This (positively) relates government spending to private consumption.

The other two links between the budget outcome and national income focus on its impact on private investment. The first of these is Minsky's argument that in an era of Big Government, the budget outcome operates as an automatic stabilizer through its impact on profitability and therefore investment (1986: 19-23; see also Wray 1989 for an extension of Minsky's argument). Minsky argues that a budget deficit in a period of recession 'subsidizes' private profits so that private investment is restored and a cumulative decline into depression is prevented. Similarly, a budget surplus arises in a boom that acts as a brake on private investment, preventing an inflationary spiral. Minsky implies that the budget outcome should be allowed to 'run its course' over the cycle, rather than attract the direct attention of policy makers. The economy generates a surplus when it needs one, that is when the economy is approaching its full capacity limit and risks entering an inflationary period. Generating a surplus earlier than this will only bring forward the downturn, before the economy's upper limit is reached. Similarly, a deficit plays a functional role in ensuring that a recession does not tip the economy into a secular decline.

In a similar vein, Aschauer (1989a, 1989b) has argued for a complementarity (see also Erenburg 1993, and Munnell 1990) between government spending and private investment. Aschauer's argument is slightly different, though, from that of Minsky in that he focuses on a particular form of government outlays, regardless of whether it is part of an overall deficit or surplus. His argument is also distinct from that of Minsky and the Keynesian view in that it addresses the relationship between this type of spending and the *secular* growth path of the economy, rather than the cycle. Neoclassical theory does not differentiate between types of government spending, regarding all government spending as a diversion of resources away from the (more productive) private sector; any reduction in government spending will therefore benefit the economy. Aschauer, on the other hand, argues that government spending needs to be differentiated into its current and capital components. He argues that the decline in public capital accumulation, especially in core infrastructure areas of roads, highways, water systems, sewers, and airports, explains a large part of the productivity slowdown that has taken place in the United States since the 1970's. Along with this decline in productivity has come a decline in private profitability and, subsequently, private investment. In other words, public capital expenditure will 'crowd-in' private investment, contrary to the conventional wisdom.

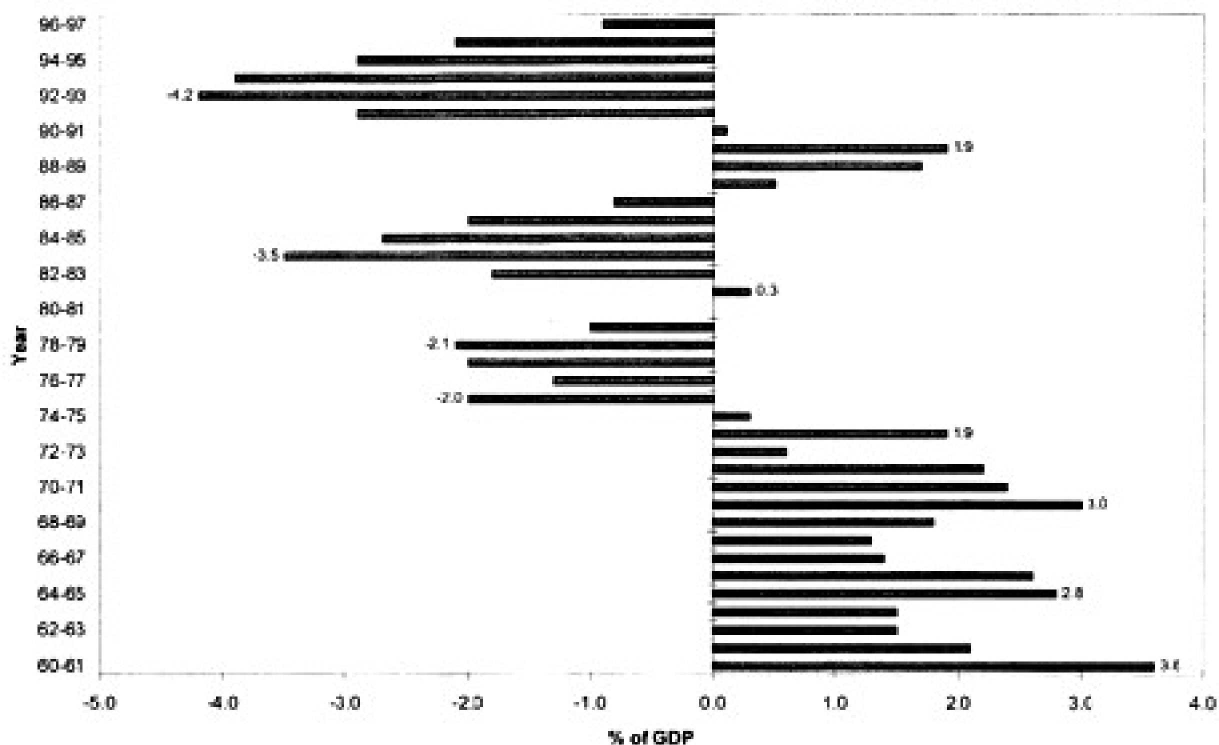
Kearney, Chowdhury and Fallick (1994) have applied Aschauer's analysis to Australia. They noted the compositional changes that occurred in the structure of government outlays through successive attempts at reducing the deficit, and the resultant impact on private sector activity. Their empirical results suggest that for every $1 of public investment there is an equivalent amount of private investment 'crowded in'. The converse argument also applies: reductions in government capital spending lowers private investment and thereby produces a decline in economic activity.

This paper takes this line of reasoning one step further by feeding the impact of outlay reductions on economic activity back onto the government's budget outcome, so that a self-reinforcing spiral emerges. The resolute pursuit of deficit reduction has set up a vicious cycle whereby the government's attempt to reduce outlays reduces economic activity, and this then feeds back on future outlays and revenue. Indeed, over time outlays may not be reduced since the decline in economic activity may increase other demands on government spending such as unemployment and welfare payments. The result will be the re-emergence of a deficit, which,

if again attacked on the same logic, will continue the downward spiral. And with the budget outcome over the cycle on average being in deficit, this will further exacerbate the problem in subsequent periods as the interest payments that results from the increase in debt begin to accumulate over time. As soon as the government targets an average balance as the budget outcome it creates the conditions that ensure the budget outcome will on average actually be in deficit. The ironic outcome of this spiral may be that as a percentage of GDP the Budget deficit remains constant *or in fact grows* .

The Budget Outcome

As noted above the objective of 'fiscal consolidation' has been pursued on the basis of the following, deceptively simple, logic: if outlays exceed revenue, the two can be balanced by cutting outlays. Yet the actual budget outcomes[1] for this period indicate that this objective has not been consistently met, as illustrated in **Figure 1**.



There are a number of aspects to the pattern exhibited by the Federal budget outcome since 1960. The first is the sharp juncture in 1974: prior to this the Federal budget outcome was always in surplus. Since that time, in a majority of years the budget has been in deficit. The second notable aspect of this picture is the way in which the budget cycle, as it traces the business cycle, has had a larger amplitude, with ever larger surpluses in the upswing giving way to ever larger deficits in the subsequent recession. The reduction in outlays has only *temporarily* produced a surplus over the course of the last three business cycles. With each successive downturn the deficit as a percentage of GDP is worse than the corresponding point on the previous cycle.

The government has clearly not been able to achieve its objective of an overall balance over the course of the cycle; on average the budget remains in deficit. In fact, since 1974-75 the budget outcome as a percentage of total GDP was -1.5%. This contrasts sharply with the post-war period up to 1975-76 when the budget outcome for each year was in surplus.

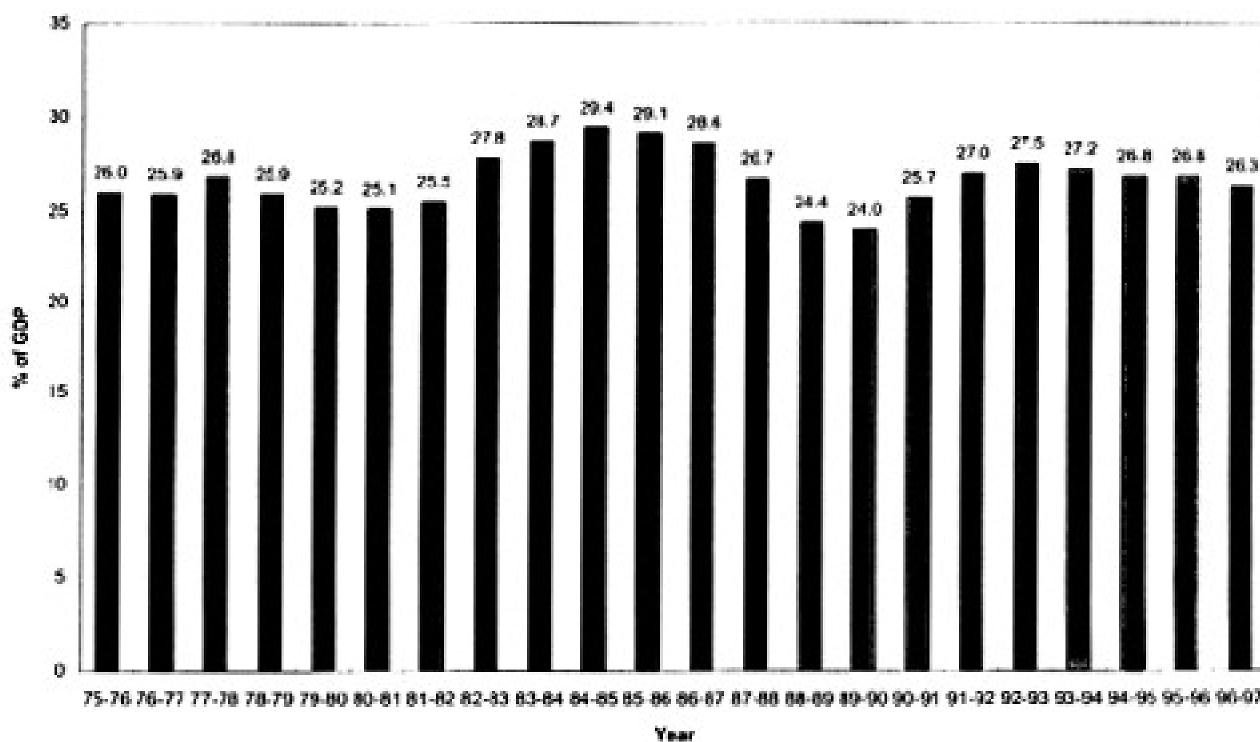
Clearly, the strategy of fiscal consolidation through outlay restraint has not been successful. Why? The crucial issue, as discussed above, is the impact of fiscal consolidation on national income. Following the Keynesian and Minsky arguments, fiscal consolidation makes the amplitude of the business cycle worse than it may

otherwise have been. And according to Aschauer, if this leads to a reduction in government capital outlays, the long run growth path of the economy may be negatively affected. If this is the case then the impact of any given year's expenditure reductions on expenditure and receipts in subsequent years may make the budget deficit larger than it was originally, thereby explaining the pattern outlined in Figure 1.

The failure to account for the negative impact of the fiscal consolidation strategy on national income is clearly evident in the relationship between the government's *expected* outcomes for budget outlays, announced at the start of each budget year, and the *actual* outcomes. In the decade between 1985-86 and 1995-96, the government underestimated its outlays bill by an average of nearly $1 billion each year. On only 2 of these 10 years did actual outlays not exceed expected outlays, when the economy was emerging out of the deep recession of the early 1990's.

Government Outlays: Capital and Current

The Government's attempt to reign in the budget deficit has been thwarted by the tendency for outlays to increase during times of economic recession (along with falls in revenue), a process illustrated in **Figure 2**. This is especially noticeable for the most recent cycle, where outlays as a proportion of GDP fell to 24% in 1989-90 only to peak again at 27.5% in 1992-93.



The important factor is the way in which the *composition* of outlays has changed over the course of the cycle. Capital outlays consist of expenditures on items that are intended to yield a benefit over time rather than in just the period in which they are purchased. The major categories of capital outlays are:

- Capital outlays on Goods
- Capital outlays on Land
- Capital Transfer Payments to State and Local Governments and other Sectors

Current outlays, on the other hand, have a substantial non-discretionary component. These are the so-called automatic stabilizers which 'kick-in' as the economy moves into recession, generating an increase in government spending to offset the decline in private activity. The main categories of these outlays are:

- Final Consumption Expenditure (Defence and Non-defence Salaries)
- Current Transfer Payments (Interest payments, Subsidies, Personal Benefit
- Payments, and various Grants to other governments and institutions)

Over the past 20 years there has been a tendency for capital outlays to fall as proportion of total outlays.

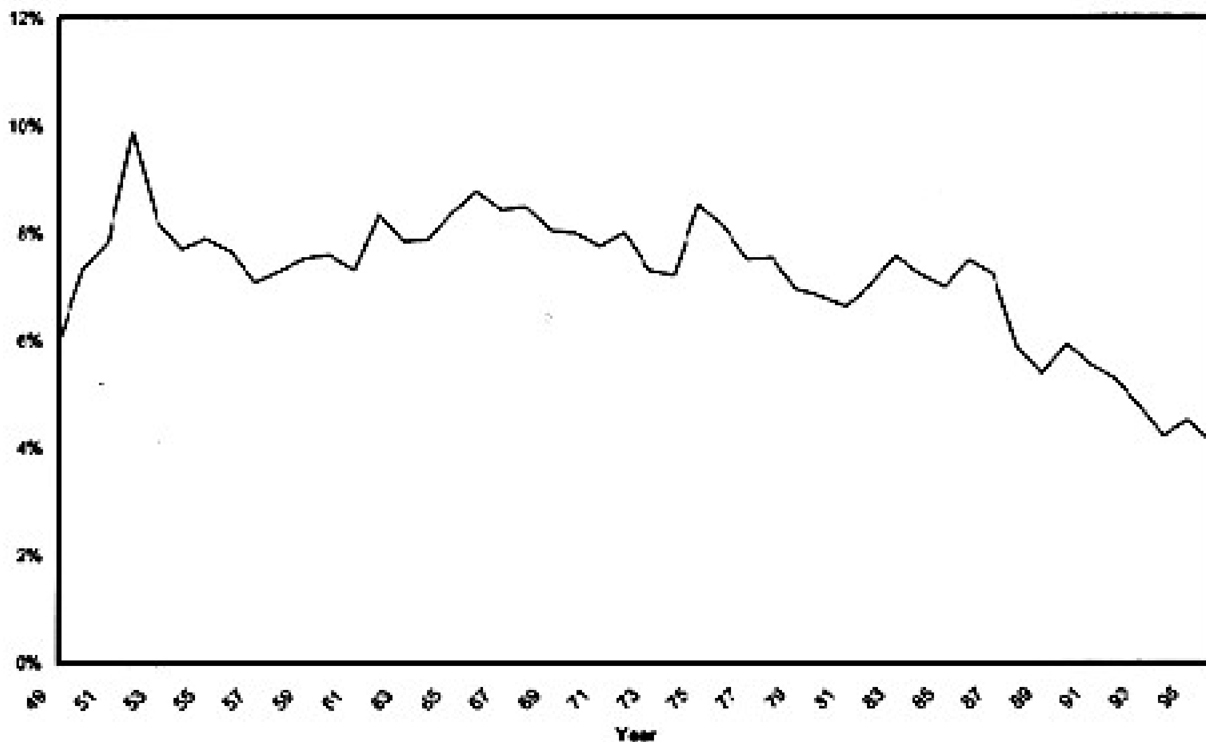
It is clear then that capital outlays have borne a disproportionate share of the cuts imposed as part of the strategy of fiscal consolidation, so that *the reduction in total outlays has been achieved almost completely at the expense of capital outlays* . It is especially noticeable that the sharp reductions in capital outlays after 1992-93 coincides with the largest deficit as a percentage of GDP yet recorded, reflecting the government's reliance on these forms of expenditure as a quick means of reducing the deficit in any given year.

Table 1: Commonwealth Current and Capital Outlays

Year	Current Outlays % of Total Outlays	Capital Outlays % Total Outlays
1980-81	93.9	6.1
1981-82	93.9	6.1
1982-83	93.4	6.6
1983-84	93.3	6.7
1984-85	93.0	7.0
1985-86	93.3	6.7
1986-87	93.8	6.2
1987-88	94.6	5.4
1988-89	94.9	5.1
1989-90	94.7	5.3
1990-91	94.0	6.0
1991-92	94.7	5.3
1992-93	94.3	5.7
1993-94	96.2	3.8
1994-95	96.9	3.1
1995-96	97.0	3.0
1996-97	96.9	3.1

Source: Commonwealth of Australia, *Budget Papers* , various years

Current outlays, on the other hand, keep 'bouncing back' as a proportion of GDP with each economic downturn. Current outlays, for example, returned almost to the same point in 1995-96 as they were in 1985-86, whereas capital expenditures, at only 0.8 per cent of GDP, are all but negligible by this point. Indeed, as **Figure 3** shows, the decline in Federal capital expenditures is part of a decline in all levels of government investment. The level of public investment was remarkably stable during the 1950's and 1960's. In the early 1970's a decline began that has gained speed in the last decade, so that in 1996 public investment was at 4% of GDP, less than half its post-war peak of 9.9%.



The reason for this change in the composition of outlays is due to the fact that capital outlays are largely *autonomous* expenditures, whereas current outlays are *endogenous*. Cuts in the autonomous component of outlays may produce an immediate windfall gain, but over time feed back as an increase in the endogenous component of outlays. As an economy moves into recession, the need to pay more unemployment and social security benefits induces an increase in current expenditures. Of course, the government can introduce policies which reduce the extent to which the business cycle induces these expenditures, for example by tightening the eligibility criteria for unemployment benefits, but nevertheless a large part of current outlays is determined by the state of the business cycle.

We have seen how the composition of outlays has shifted away from capital outlays and toward current outlays. There are, however, important compositional changes within the current outlays category, which also affect the stability of the budget outcome. Most significantly, social security and welfare payments have increased in importance, making the government's outlay account even more susceptible to economic fluctuations. In 1988-89 Social Security and Welfare payments were 28.9% of Total Outlays, but within a decade this has grown to 37.8%.

The failure of successive Australian governments to eliminate net deficits over time has meant that, rather than reducing the rate of public debt, public debt has been accumulating over the past 20 years.

Table 2: Commonwealth General Government Net Debt

Year	Commonwealth Net Debt, % of GDP
1974-75	-1.2
1975-76	0.9
1976-77	2.0
1977-78	3.8
1978-79	5.2
1979-80	5.6
1980-81	4.9
1981-82	4.1
1982-83	5.6
1983-84	8.4
1984-85	11.3
1985-86	11.3
1986-87	11.0
1987-88	9.1
1988-89	6.5
1989-90	4.3
1990-91	4.4
1991-92	8.0
1992-93	13.5
1993-94	16.2
1994-95	18.1
1995-96	19.5
1996-97	18.3

Source: Commonwealth of Australia, *Budget Papers* , 1998-99,
No. 1 Statement 7.

Successive governments have pursued a budget surplus in order to retire old debt and thereby offset the increase in debt that will arise when the business cycle downturn produces a deficit. However, with deficits being larger and more persistent than the surpluses (Figure 1), the net effect over time is an increase in debt. This has then only heightened the government's resolve, based on the same spurious neoclassical logic, to achieve greater surpluses in order to reduce the ever-mounting debt, continuing the self-defeating cycle. This calls into serious question the current target, announced in the recent *Budget* to halve the ratio of Commonwealth general government net debt to GDP from 20% to 10% by 2000.

The failure of fiscal consolidation to reduce public debt helps explain the push for the privatization of public assets that has occurred over the past 10 years.

Table 3: Asset Sales, 1985-86 - 1995-96

Year	ASSET SALES $million
1985-86	0
1986-87	0
1987-88	1056
1988-89	528
1989-90	1065
1990-91	161
1991-92	302
1992-93	800
1993-94	2453
1994-95	55
1995-96	5350

Source: Commonwealth of Australia, *Budget Papers* , 1995-96, No. 1.

With the failure of the fiscal consolidation strategy to produce an average budget outcome of zero, the government has relied on asset sales as the means by which the growing debt burden can be contained. But here again a momentary gain may produce a long term problem as the loss of future earnings that would flow from these assets reduce future revenues. And if the private sector owners of these newly privatized assets are reluctant to maintain the rate of investment that would have prevailed if they had remained in public hands, the long term effect on national income will also undermine the fiscal consolidation strategy.

Conclusion

Minsky argues that there is a 'natural dynamic' between the budget outcome, private activity, and the course of the business cycle. The effect of this cycle is to stabilize the economy and prevent recessions spiralling downward into depressions. Thus the economy, in a sense, gets the deficit or surplus it needs. This stabilization process is upset, however, as soon as the government tries to control the process to achieve certain budget outcomes. Trying to eliminate a deficit and force a surplus through outlay reductions biases the business cycle downward so that on average a deficit persists. This is because, in trying to impose itself on this 'natural cycle', the government can only really affect its discretionary expenditures which are mainly capital outlays. Yet these are precisely the type of outlays that sustain the secular growth path of the economy through their crowding-in effect on private investment.

This raises the question of the viability of the Australian Federal Government's budget strategy of fiscal consolidation: can expenditure cuts eliminate a fiscal deficit? The answer is 'No'. When capital outlays are reduced there may be a temporary reduction in the deficit as a proportion of GDP, or indeed a surplus. However, these gains prove illusory precisely because cuts in these outlays increase the severity of the business cycle and push down the long run growth path of the economy, so that the Government finds itself in a worse budgetary position in subsequent periods than initially was the case.

In other words, the annual focus on the aggregate fiscal outcome (the deficit/surplus) masks important compositional changes to government outlays induced by the very act of targeting this aggregate; compositional changes which raise questions about the impact of the budget strategy on long term growth prospects and therefore the ability to meet the fiscal consolidation objective.

The conclusion that follows from this analysis is that the government should not seek to achieve any particular target budget outcome. Instead, the government should assess individual spending programs on their respective

merits, and let the overall budget outcome emerge as a 'residual'. Indeed, not intentionally aiming for a budget balance may be the best way of achieving it in a sustainable way, especially if the government ensures an adequate level of public capital expenditure. This may seem counter-intuitive: when outlays exceed revenues increase outlays! However, by acknowledging the long term effects of particular types of government outlays it may be the case that the deficit will only be reduced in a sustainable way by encouraging those forms of outlays which improve the long-term level of economic activity. The budget outcome should be allowed to emerge as an unintended consequence of prudent decisions made about individual spending and revenue programs, and if these are conducive to private activity, the budget will move into balance, and even surplus, as was the case in Australia throughout the post-war period until the early 1970's.

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1. Throughout this paper we will use the concepts of Underlying Capital Outlays and Underlying Balance, which exclude Net Advances. Underlying outlays remove the impact of major equity asset sales which have been significant from 1987-88, and repayments of State loans, which have been subject to accelerated repayments from 1990-91, and as a consequence can exhibit quite different growth rates from total outlays" (Commonwealth of Australia, 1996-97 *Budget Papers* No.1, 3-30). Since the Government can cover a deficit in any given year through these advances the so-called 'Headline Balance' which includes Net Advances may be a misleading indication of the Government's budgetary position.