Budget 2010 Will Be Test of Government's Resolve

Last month the government released its Budget Policy Statement (BPS) for 2010, along with its 2009 Half Year Economic and Fiscal Update.

Shortly the Finance and Expenditure Committee of parliament will be considering submissions on the BPS and the process of putting together the budget will be in full swing.

The first BPS was produced as required by the Fiscal Responsibility Act 1994 (which is now part of the Public Finance Act) in February 1995. Together with the requirement to publish pre-election fiscal updates, the revised budget process has brought somewhat more discipline and transparency into the budget process.

There are still weaknesses, however. The original concept was for the select committee’s consideration of BPS submissions to be a meaningful two-way dialogue with the government that would influence budget decisions.

This has never happened. It has become progressively a pro forma exercise, and the Committee’s report is of little consequence. One by one business organisations have stopped making submissions. For the first time the Business Roundtable is not making one this year.

Another weakness relates to the substance of fiscal policy. The fiscal responsibility legislation has made governments and the public more conscious of budget deficits and public debt after the excesses of the Muldoon years. However, it has done little to cut wasteful government spending, and thereby the overall tax burden.

A glance at the first BPS in 1995 illustrates this point. The legislation requires the government to set out its long-term and short-term fiscal intentions.

In the document, the minister of finance, Bill Birch, stated that the government's long-term objective was to reduce expenses as a percentage of GDP "from current levels of around 36% to below 30%".

Its short-term intention was to hold expenses stable in nominal terms from 1995/96 to 1997/98 so that their share of GDP would fall to 30.2% in 1997/98.

Those goals were not achieved. Only in the mid-2000s, at a time of relatively strong growth, did the ratio briefly dip below 30% (some changes in accounting treatment make the figures not precisely comparable). The latest BPS shows core Crown expenses running at 35.5% of GDP and falling only to 34% by 2014.

Much budget commentary focuses on the operating balance and Crown debt. These are important: the current BPS forecasts an operating deficit of $6.7 billion for 2010/11 and net debt is forecast to treble by 2014 to $65 billion. The costs of servicing this debt are rising fast, to a projected $4.6 billion by 2014, more than the government spends on 'law and order' and on its 'core services'.

However, government spending should be the main focus of budget scrutiny. It drives the government's tax and borrowing requirements, and the quality and size of spending have pervasive impacts on the economy and the overall well-being of citizens.

In its 2009 report on New Zealand, the OECD noted that "econometric evidence for OECD countries indicates that large government size may be detrimental to growth in living standards. This evidence shows that each percentage point in total government spending as a share of GDP reduces the growth rate of real GDP per capita by 0.13 percentage points per year."

The report added, "The recent rise in government expenditure … is thus a disquieting development for an economy already suffering from sluggish per capita GDP growth".

It's therefore unsurprising that the first recommendation of the 2025 Taskforce on a strategy for catching up to per capita income levels in

Australia was to return the government spending ratio to the level of the mid-2000s. It also advocated a legislated cap on future spending growth.

The 2010 BPS foreshadows greater spending discipline. Smaller allowances (of $1.1 billion) are made for additional spending this year and next, and the government is committed to exploring a spending limit. The Business Roundtable has advocated a rule that limits spending growth to population growth plus inflation, unless the government obtains taxpayers' agreement to higher increases through a referendum.

Tax changes in the budget should be funded by spending reductions, not new taxes. The government should also consider how to make the BPS process more meaningful.

Around the world the global financial crisis is being succeeded by a fiscal crisis for many governments. Even in Australia, one of the least affected countries, the government has announced a 2% per annum cap on the growth of new spending. The forthcoming British election seems likely to be dominated by a debate on reductions in public spending.

To date, our government has not made hard spending decisions, partly out of a concern to support activity during the recession. However, the 2010 BPS signals the need to take firmer action in the context of its 2025 goal. In this year's budget we will have an indication of whether its resolve is consistent with the goal it has set itself.

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