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Heather Ridout
Chief Executive Australian Industry Group**

A Matter of Give and Take

The job confronting the Government in framing next Tuesday's Federal Budget is about as tough as it gets. The developed world is in recession; the domestic economy is in a similar position; the world's financial markets remain in a fragile state; and uncertainty is pervasive.

In assessing the Government's approach to this task, Ai Group will look not so much at the inevitable headline deficits for 2009-10 and beyond. We will look, rather, at how well the Government manages the "give" needed to support and stimulate the economy and how it plans the "take" needed to bring the budget back to surplus and to pare back the debt levels built up to manage through the recession.

A critical element in both the "give" and the "take" will be the recognition of the importance of productivity-enhancing programs in investment, infrastructure, innovation, workforce training and export market development. Notwithstanding the pressures to be rigorous in managing expenditure, it is vital the Government harnesses the critical role of business in driving Australia out of recession.

Despite the cricket scores being forecast for Tuesday's Budget bottom line and that of the next few years, Australia's public debt position will remain in great shape in a comparative sense thanks in large measure to the legacy from the previous government. A future debt figure of around \$200 to \$300 billion could see Australia's public sector debt reach between 15% and 25% of GDP. However, this compares favourably with current levels in the US and Germany which are already well above 60% – even before their looming debt explosions hit their balance sheets.

It's reasonable then to ask why should we worry about future levels of our debt. Unfortunately, we have allowed ourselves to become hooked on foreign borrowing to run persistent current account deficits in financing high levels of private spending.

We have worried about this problem for over 20 years, but no monetary methadone in the form of comparatively high interest rates seems to have worked. We are still hooked. That means we have to worry about fickle foreign inflows to balance our books. Whether reasonable or not, foreign lenders find growing public debt positions unappetising at best and worrisome in reality.

There is an overwhelming case for public support to the economy and a consequent fall into deficit financing. Similar forces are producing similar responses just about everywhere around the world.

Unless the world economy recovers unexpectedly quickly, we will see deficits and additions to public debt for a number of years.

What matters is not debt as such, but sustainable debt that we can afford. That is easily the case today, but it will not always be so if spending is allowed to proceed unchecked.

As Ai Group has been arguing for some years, future public debt interest payments are an appropriate price for our children and grandchildren to pay if they relate to expenditure on high-return, and rigorously-assessed physical and human infrastructure.

In contrast, debt related to shortfalls between recurrent expenditure and revenues needs to be limited strictly to downturns in the economy and then repaid as quickly as possible.

The essential thing is to keep a close eye on the way debt to GDP ratios evolve. That is why initiatives that have expiry dates like one-off cash bonuses, investment allowances and infrastructure programs have been popular. They offer much-needed support today while reducing unwanted legacies for future budgets.

A focus on debt to GDP ratios can guide us to a sustainable path both by controlling debt and by promoting GDP. Measures that promote GDP are doubly blessed. Not only will rising GDP soften the ratio for any given debt level, higher GDP brings in a bounty of extra revenue for Treasury coffers that will act to curtail deficits.

At its most fundamental, achieving higher GDP is a matter of raising productivity and participation. Ai Group will judge the budget proposals on how they affect these two crucial variables.

Specifically, as to Australia's productivity performance that has been waning this decade, dollars judiciously allocated to improving infrastructure, education and training, innovation and export capabilities are needed.

In short, Ai Group will want to see a budget that sets the path back to operational surpluses; that proposes a credible plan for long-term reversals of rising debt ratios; and that gives attention to raising GDP. Ensuring that stimulus measures are temporary and otherwise tightening spending in future years have important roles to play. However we need to be wary of pruning spending that contains the seeds of longer-term productivity and participation gains.

This is what the Australian Industry Group will look for in next week's news. We think it will also be the viewpoint of foreign investors, who might not have mattered had we not become so dependent on their support. But we remain hooked.