BRIEFING

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The economics of budget surplus versus deficit

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Canberra

Centre for International Economics
Ground Floor, 11 Lancaster Place
Majura Park
Canberra ACT 2609

GPO Box 2203
Canberra ACT Australia 2601

Telephone +61 2 6245 7800
Facsimile +61 2 6245 7888
Email cie@TheCIE.com.au
Website www.TheCIE.com.au

Sydney

Centre for International Economics
Suite 1, Level 16, 1 York Street
Sydney NSW 2000

GPO Box 397
Sydney NSW Australia 2001

Telephone +61 2 9250 0800
Facsimile +61 2 9250 0888
Email ciesyd@TheCIE.com.au
Website www.TheCIE.com.au

Key points

- There are a number of complex trade-offs involved in deciding whether or when to run a budget deficit and how quickly to return a budget to surplus.
- While the question of whether the opportunity cost of funds is higher than the value of the new investment funded by government borrowing is an important one, it is not the sole consideration. Other considerations include making adequate provision for risk management and ensuring that there is the capacity to quickly move the budget into balance when required to fit conditions of the economic cycle (i.e. whether the economy is still in a downswing or is on an upswing).
- The current ACT budget is structured to enable new borrowings to be repaid within a relatively short period of time and thus demonstrates a preference for a quick return to surplus.
- At the same time, a key focus for the ACT is to ensure that spending programs take into account the role of additional spending, particularly capital spending, in boosting the flagging state of demand in the ACT economy.
- Holdings of unencumbered cash are being run down significantly to ensure that the new borrowings to fund these spending programs can be repaid quickly, consistent with the preference for a swift return to surplus. While this may come at the expense of some degree of risk management and potential flexibility that could come from having a larger unencumbered cash, it is a decision that reflects the trade-offs required to ensure that a surplus can achieved at an appropriate stage of the economic cycle and to reduce overall borrowing costs.

The budget demonstrates a preference for achieving a surplus rather than running a deficit

The budget will require new borrowings of up to $790 million over 2012-13 to 2013-14, which is an increase in new borrowings of $490 million from the previous budget. However, the budget is structured to enable this additional $490 million to be repaid by the end of 2015-16. Thus the new borrowings (and the additional interest repayments associated with these new borrowings) will only be incurred for a relatively short period of time.

Surplus versus deficit: What's the difference?

The underpinnings of macroeconomics are that the budget balance should be countercyclical – working against the cyclical tendencies of the economy by stimulating the economy during periods of falling demand while ensuring that it does not, through the government's call on funds or use of resources, contribute to inflationary pressures when the economy is returning towards a phase of nearly full employment of labour and capital.

This means that there are a number of tradeoffs and considerations which should be taken into account when deciding whether or when to run a budget deficit and how quickly to return a budget to surplus. These are summarised in the table below.

1 Trade-offs to consider when deciding on the government budget balance

Surplus-based considerations	***Deficit-based considerations***
Returning to surplus or balance quickly can reduce interest costs associated with additional borrowings because funds are borrowed for a shorter period of time.	As budgets should be countercyclical, deficit phase should be sustained as long as necessary to ensure government spending can boost private demand as long as needed.
As budgets should be countercyclical, need to have sufficient flexibility to bring balance back to surplus just in time for re-emerging private demand to rise to minimise inflationary pressures. The larger the deficit at any point in time, the more difficult it will be to bring the budget back to balance in time.	If value of investments funded by new borrowings exceeds the opportunity cost of funds, they should proceed.
Need to ensure that surplus or return to balance through faster repayment of borrowings is not achieved at the expense of reduced risk management and flexibility for instance by significantly depleting unencumbered cash reserves.	While theoretically, deficit spending is necessary to boost flagging demand during periods of economy wide contraction, there is frequently a 'lag' in impact of fiscal stimulus and therefore a need to ensure the stimulus is timed appropriately so as not to spill over into a period of recovery when it may contribute to inflationary pressures

Source: The CIE

The case of the ACT Budget for 2012-13

Borrowings which are ultimately used to finance assets that increase the productivity capacity of the ACT economy would be appropriate if the capital works and expenditure program set out in the Budget enables any borrowings to be used to increase the long run productive capacity of the ACT economy.

Borrowings are justifiable if these investments over the long run result in an increased revenue base because of higher ACT economic growth. In effect, under such conditions the value of the investment can be said to exceed the opportunity cost of those funds.

A key focus for the ACT is to ensure that spending programs take into account the role of additional spending, particularly capital spending, in boosting the flagging state of demand in the ACT economy that is being manifested in, among other things, a softening ACT building sector.

Fortunately the ACT has sufficient holdings of unencumbered cash to enable this to happen, although holdings of unencumbered cash in the Territory Banking Account are being run down by 99 per cent between 2012 and 2013 to achieve this.

While this reduces the burden of repayment that would otherwise be associated with having these new borrowings on the budget for a longer period, this is at the expense of some degree of risk management and potential flexibility in responding to any emerging liquidity needs that could come from having a larger unencumbered cash balance. Whether this trade off is ‘worth’ it is subjective, and depends on assessments of the future need for unencumbered cash balances.

While unencumbered cash balances and hence the potential for flexibility in meeting immediate liquidity needs will be reduced, assets in the Superannuation Provision Account are increased and the government expects long term returns from its investment portfolio to be maintained.

Bearing in mind the considerations set out above, the reduced flexibility that can come from having a larger unencumbered cash reserves needs to be balanced against another dimension of flexibility – the flexibility of ensuring that the budget can be ‘primed’ to move into balance or surplus when economic conditions dictate i.e. during a period when private demand has sufficiently recovered so that the government does not contribute to inflationary pressures or ‘crowd out’ private investors.