

**Howard Government Retrospective II,
University of NSW, Canberra
15 November 2017**

**“To the Brink 1997-2001”
Black Holes to Surplus Budgets**

Speech by Hon Peter Costello AC

Black Holes to Surplus Budgets

The last Budget of the Keating Government was delivered by Ralph Willis on 9 May 1995. “The Budget delivers a surplus in 1995-96 of \$718 million”, he said and went on: “Importantly, the Budget for 1996-97 will be in surplus excluding asset sales and special debt and capital repayments. And the budget surplus by 1998-99 will be \$7.4 billion or 1.2 percent of GDP”

Chart 1 of Budget Paper No. 1 (see Annexure A) showed a Budget with surpluses right across the forward estimates.

Now one had to be careful with these sorts of claims.

In those days, the Government reported what we now call a “Headline Balance”. If the Government sold an asset, the full amount of the proceeds were included on the bottom-line. Believe it or not it was treated as a “negative outlay”, effectively a cut in expenditure. So, in the 1995-96 Budget when Willis announced the sale of the Commonwealth’s remaining 50.4% equity in the Commonwealth Bank in two instalments, one to be received in 1995-96 and the other in 1997-98, the Budget bottom line was boosted by these one-off receipts from privatisation.¹

Of the year in between, 1996-97- the first Budget for an incoming Government- Willis went out of his way to say it would be in surplus “excluding asset sales and special debt and capital repayments”. In other words, it would be an “underlying surplus”- the measure we now use to present and report Budgets. It would be a real Budget surplus.

The election was due in early 1996, and the Treasurer released his mid-year review of the Budget on 21 December 1995. I don’t want you to think this looked anything like the way things are done today. It was a three-page Press Release with 2 tables attached (five stapled A4 pages). What we do today was what I introduced from 1996. The MYEFO (as it came to be called) was first released (by me) on 28 January 1997. It was a Statement of 100 pages detailing policy decisions taken subsequent to the Budget and their financial effect. Importantly, it updated forecasts and projections right across the forward estimates (see more below).

In the December release, Willis confirmed the 1995-96 Budget would still be in “surplus” because the Victorian Government had repaid some debt it owed the Commonwealth earlier than expected. Of course, it was ridiculous to count this on the Budget bottom line, and no-one would dream of it today. But that was how things were done in those days.

Willis made no update of what really mattered- the starting point for the next Budget, the 1996-97 year, which would be the first year of the next Government.

A month later, on 27 January 1996 the Federal election was called.

On 10 February 1996 I wrote to the then Secretary of the Treasury (Ted Evans) asking if Treasury had more up-to-date projections for the 1996-97 year, and said: “If the Departments [Finance and Treasury] stand by the projections for 1996-97, I request official written confirmation”. The letter was copied to the Treasurer.

¹ The Budget disclosed that in 95-96 asset sales were adding \$5.4 billion to the bottom line (or in the fantasy of the day reducing overall outlays by \$5.4 billion). No breakdown was provided for future Budgets. However, it was clear from the Treasurer’s announcement that CBA privatisation would be adding to the 1997-98 “surplus”.

On 12 February Evans replied saying ‘...issues relating to the release of forecasts and projections, including both content and timing, have always been matters for decision by the Government’.

Willis replied the same day saying the Mid-Year review was confined to the Budget year only (and therefore not the year that mattered, 1996-97) and “...the Government sees no reason to change its well established policy on this matter”

So that’s where things lay. The Government projected a Budget surplus for 1996-97, a real Budget surplus without asset sales or other tricky one-off payments. That was the official ground on which the 1996 election was fought.

During the campaign PM Keating re-affirmed that the 1996-97 Budget was projected to be in surplus and the forecasts were correct. Finance Minister Beazley said on 1 February “...We’re operating in surplus, and our projections are for surpluses in the future...” and further: “...the Treasury estimates that we had... in connection with the last Budget, and they were Treasury estimates, they stand for good, and we stand by them.”

The election was held on Saturday 2 March. On Monday 4 March 1996, I flew to Sydney and met with the Treasury where I was presented with the Blue Book. As you know during the Caretaker period in an election, the Public Service prepares a brief for the incoming Government- the Red Book for Labor, the Blue Book for the Coalition. The Blue Book ran to around 300-400 pages. Lest I missed the most important point, the cover page of the Blue book had a graph on the front. It was the Budget balance. (My copy is re-produced at Annexure B). The Budget was not in surplus. Across the forward estimates to 1998-99 it never would be in surplus. This Graph looked nothing like the estimates that had been published in the 1995-96 Budget (contrast Annexure A with Annexure B).

I released the forward estimates in the Blue Book via a Press release on 12 March. It showed, the starting point for the 1996-97 Budget was an underlying deficit of \$7.6 billion. To be clear, these were not my figures. These were the figures prepared for the incoming Government whoever it was - either Labor or Coalition- by the Treasury.

The Blue Book had presumably been put together in February, right at the time Ted Evans was telling me it was up to the Government as to whether forecasts would be released. It was prepared right at the time Ralph Willis was saying he would not release updates, and right at the time Keating and Beazley were maintaining the Budget for 1996-97 was in surplus.

According to the Treasury, the starting point was a deficit of \$7.6 billion or 1.5% of GDP. Today that would be around \$26 billion. (In fact, the Government forecast for this year’s Budget is 1.6% of GDP or \$29 billion).

As it turned out the 4 March forecast was still optimistic. By the time I delivered the Budget in August it was estimated that the deficit on a “no policy change” basis would be \$9.6 billion, around 2% of GDP.

This was the famous “Black Hole”. A Budget declared to be in surplus in February was \$8 billion in deficit on 4 March and \$10 billion deficit by August. Sometimes the black hole will be described as \$8, sometimes \$10 billion depending on which of the estimates (March or August) you are referring to.

What was Labor’s response?

It varied over the years. Sometimes Labor figures claimed there was no 'Black Hole', that this had been conjured up for political advantage. Beazley initially claimed this. How we had tricked the Treasury into drawing up these figures before I had even become Treasurer was something that was never explained. I can tell you that in March 1996 Treasury Secretary Ted Evans knew a lot more about Budgets than me. It was well above my ability to pull one over him. They were his figures not mine.

Some in the Press- even the cynics- suggested this was not new news, that we all should have known that the Budget was in deficit "because everybody knew". On this theory we pretended to be surprised so we could cut expenditure more drastically than promised. Let me say quite clearly- on the contrary, that everybody did not know. I certainly did not. Most of Press had, in fact, been lauding the Government for its fiscal policy which had balanced the Budget before the election.

And the outcome did not suit me at all. I had hoped that with our announced program of savings we would fund our policies and keep the Budget in surplus. It was no fun when it dawned on me that we would have to find a new \$8 billion in net savings just to get back to the starting point!

We did not have a majority in the Senate. And let's be clear about one thing. We were given no quarter by our opponents. The idea that in "the old days" the Opposition co-operated to allow a Government to implement its policy is fantasy. Labor fought every expenditure cut and eked out every vote it could from the political difficulty of cutting spending.

On the eve of the Budget the ACTU organised a huge protest rally outside Parliament House. Some militants smashed their way through the front doors of the Parliament building. I describe this in the Costello Memoirs, Melbourne University Press 2008, p.100.

The next day I delivered the 1996-97 Budget, and said-

"Our predecessors had Australia on a path of deficit and debt to the next Century...

Our Government could not stand back and ignore the problem. Although we did not create it, we will take responsibility to fix it."

The Plan was to close the Budget deficit of 2% over two years by cutting outlays by 1.8% of GDP and increasing revenues 0.2% of GDP.

The record shows, in fact, that over two years outlays were cut 1.7% and revenues rose 0.4%. The Budget balanced in 1997-98. The only time there had been a fiscal consolidation anything like that had been 1987-1990, but it proved unsustainable and the Budget plunged back into deep deficit after that. There has been no comparable fiscal consolidation since.

The 2% deficit was too big to close in one year, so our first Budget was a deficit. Over 12 Budgets, there would only be one other. That was in 2001-2002 (a deficit of -0.1% of GDP). It is outside the timeline of this Conference, so I will not deal with it in detail here. Put simply it was a time of mild downturn (internationally the Tech wreck and domestically the GST) coupled with the unexpected expenditures of war and terrorism in the wake of September 11 attacks.

A line of revisionism we began to hear when Labor was having trouble balancing Budgets a decade later was that the Coalition only balanced Budgets because there were rivers of tax revenue flowing from the mining boom. So, for the record, the mining boom peaked in 2011 (Julia Gillard was Prime Minister). For a short time, the iron ore price went to US\$180 per tonne. Of course, the Budget was then in deficit. Today the price is around \$60 per tonne. The Budget is still in deficit.

When I delivered the Coalition's first balanced Budget in 1997-1998 the iron ore price was around US\$13 per tonne. It was still around that mark 3 years later in 2000-2001.

In the 1990s and early 2000s commodity prices were not booming, they were depressed. It was not until 2005 that prices began to rise significantly. By then I had already delivered 7 surplus Budgets.

One thing that arose out of this experience which has not been adequately recognised is the Charter of Budget Honesty.

In reply to the 1995-96 Budget at the National Press Club (17 May 1995), I had pledged the Coalition to a Charter of Budget Honesty. We renewed that pledge in our major economic Statement released on 30 January 1996 which was called: "After 13 years...How Labor has failed Australia" and also when I released the actual Budget figures on 12 March after the election.

Labor strongly attacked our Charter of Budget Honesty, ultimately enacted early in 1998 after considerable Senate opposition. The Charter is a law that governs how Budgets are presented. Until then the Budget and its presentation had been at the discretion of the Executive Government. The Charter requires a mid-year update of all the information contained in the Budget- MYEFO-including the forecast and projections across the forward estimates. It also requires the Secretaries of Finance and Treasury to give a Pre-election statement of the economic and fiscal outlook- PEFO- for the current year and following three years, within ten days after the issue of the Writs for an election. It provides the opportunity for an Opposition to have its policies costed.

The great success of this Act is that, since the 1996 election, the Parties have never gone into an election without knowing the true state of the books. The Charter stands twenty years later virtually unamended. It has proven its worth in seven elections, twenty Budgets, twenty MYEFOs, and twenty Final Budget Outcomes (FBO). It lays down the requirement for the Intergenerational Report every five years and the expression of a medium term fiscal policy. The official medium term fiscal policy that has been adopted by Labor and Liberal Governments since, is the one I set: - to balance the Budget over the course of the Economic cycle. Unfortunately, the Charter of Budget Honesty cannot discipline adherence to it!

The last Labor Budget in 1995-1996 had payments to GDP at 25.6%. In two years we had them down to 23.9% and by 1999-2000 we had them at 23.2%.

There is a break in the historical series caused by the introduction of GST on 1 July 2000. As you know, the Commonwealth introduced GST, the whole proceeds of which go to the States. This replaced excises that the States were no longer constitutionally able to collect, and taxes that they abolished in return for the GST-taxes such as bank taxes, stamp duties and the like. If you classify GST as a Commonwealth tax, then this re-arrangement between the Commonwealth and the States shows as a Commonwealth tax rise with an offsetting tax cut by the States.

In reality, the States cut nothing. From 2000 the States had the same amount of revenue they always had, it was just that some of it was collected by the Commonwealth as agent on their behalf. Indeed, the States pay the Commonwealth to collect it.

Not only does this collection of (previous) State taxes show up as a Commonwealth tax "increase" but because the money is remitted to the States, this shows up as a Commonwealth expenditure "increase".

If you want to compare the pre-GST position with the post-GST position you have to net out this transaction (the collection of what was previously State tax and remission of it to the States). This is

not done in the historical series and the effect is that the Commonwealth tax receipts jump, and Commonwealth spending jumps about 2% of GDP because remitting the GST to the States is treated as a payment. Of course, neither Commonwealth own purpose outlays (COPO), nor State own purpose outlays actually changed.

No matter, after this change in classification which boosted payments up again to 25.1% in 2000-01 we were able to get them down again to 23.1% in 2007-08.

In response to the financial crisis of 2008, Rudd and Swan increased payments to 26.0%. They are still well above where they were before that huge increase. If we could get them back to where they were before Rudd and Swan began that massive spending increase, the Budget would be in surplus now rather than a \$30billion deficit.

Comparison to today

In 1995-96 the Budget deficit was 2.1%. The Government is forecasting 1.6% for the current year.

In 1995-96 receipts to GDP were 23.5%. For this year the Government is forecasting 23.8%

In 1995-96 payments to GDP were 25.6%. For this year the Government is forecasting 25.2%

Today revenue is a little higher and payments a little lower than they were when the Coalition was elected in 1996. If the fiscal consolidation of 1996 were implemented today, the Budget would balance through reduced spending. The current Government's plan out to 2020 is to balance the Budget through increased tax revenues.

Net Debt

The best way of measuring fiscal policy is through the net debt measure. This is a Balance Sheet measure. The Budget is an annual Profit and Loss measure. But the annual result is reflected in the year-by-year movement in net debt.

When the Coalition was elected in 1995 the net debt to GDP ratio was 18.1%. Over twelve Budgets the net debt was eliminated. In fact, we developed net assets (3.3% of GDP). Since the election of Rudd in 2007 there have been ten Budget deficits. The combination of all those deficits has eliminated the net asset position and run net debt back up to 19.5% of GDP, a deterioration of nearly 23% of GDP.

We are back where we were in 1996. We have one advantage we did not have then: - interest rates are much lower. This means interest payments on Commonwealth debt is about 1% of GDP less than it was back then. Of course, our credit rating then was two levels below our credit rating now. We only recovered the AAA rating by a series of surpluses that allowed us to pay back debt. Our better credit rating helps to keep interest rates lower than they would otherwise be.

I do not want to under-estimate the difficulty of cutting expenditure. It usually requires legislating through a hostile Senate. It comes with political pain. And the pay-off is more in the medium and longer term. I know because I have been there. I recount some of this in the Costello Memoirs p. 97

A Policy Anchor

The primary mission of the Coalition in its first term was to balance the Budget. If we had failed in that, we would have failed as a Government. Of course, other issues arose and the Government had to attend to them as they arose-guns for example. But this was responding to events that arose outside the Government's control. What the Government sought to control was the Budget

situation. It became the driving policy principle across all Departments. It was a focus in all the decisions we took.

One person who made a significant impression on me in my early days as Treasurer was the head of the Bundesbank Hans Tietmeyer. We were both members of the Interim Committee (as it was then known) of the IMF. I remember him reflecting on one of the Latin American financial crises that seemed to be quite frequent in those days:-“You need a basis for policy. If you don’t, you will be swept from crisis to crisis. If your policy is not based on something you will find your policy is based on nothing.” Of course, the anchor for the Bundesbank was low inflation, as the country had been so scarred by hyperinflation in the lead up to the Second World War.

Our policy anchor was a balanced Budget.

If you are prepared to live with small deficits, then people will wonder why they can’t live with deficits a little bigger, or a little bigger again. If it doesn’t matter that the deficit is \$10 billion, will it really matter if it is \$20 billion, or \$30 billion? A balanced Budget is easily understood and it provides an obvious line to defend when people are advocating new spending. Once you go through that there are no natural lines of defence and it is hard to get agreement on where things should stop.

A unifying objective

In our Government we often talk about the “Central Agencies”. These are the Departments like PM&C, Treasury, Finance that are across all the Portfolios and work to the Government’s overall objectives. There are other Portfolios that are more Industry specific and deal with sub-sectors of society. Often these sub- sectors will have organised lobby-groups. They see the Portfolio Minister as “their” Minister and his/her responsibility as being to look after their interest. After a while, Ministers can see themselves in a similar way.

On this thinking, the Tourism Minister is there to look after tourism and tourist operators, the Agriculture Minister is there to look after farmers, the Minister for Industry is there to look after manufacturers. The lobby groups tend to rate the Ministers on how much they deliver to the industry in terms of spending, tariffs, preference and the like. The Ministers start to see themselves as representatives of those interests in the Cabinet, there to lobby for the interests they represent. If each pushes their own Agenda, despite push-back from Central Agency Ministers (and the force of that depends very much on who those Ministers are) the Government can be swamped by special-interest pleading- popular in specific constituencies but-with no overall coherence.

An overall unifying fiscal objective means the Ministers can go back to their interest groups and represent the Government to them rather than represent the interest groups to the Government. The sectional interest is subordinated to the national interest.

You will recall that when Malcolm Turnbull challenged Tony Abbott for the leadership of the Liberal Party and thereby the Prime Ministership in September 2015 he said that the party had been unable to develop an economic narrative. No –one could have missed the clear economic narrative of the early terms of the Howard Government- we are going to balance the Budget, we are going to pay down Labor’s debt, after that we will reform and lower tax. In later days I would argue that we had to prepare for the Ageing of the population.

Call it a narrative, or call it a unifying objective, but it had the great advantage that the public had a clear idea of where we wanted to go and it gave the Ministers a clear direction on the overall objective as well.

Ministerial discipline

If you want to unify Ministers around a common goal, it is important that they feel they are sharing the burden. As I said, they have lobby-groups and Departments telling them that their duty is to go into the ERC (the budget committee of Cabinet) or the Cabinet itself and bring home the lolly. Nothing is more dispiriting to a Minister who has taken a firm line against spending in his/her portfolio to watch it frittered away to someone else's policy proposals or interest groups. You can only maintain discipline if everyone thinks it is being maintained generally.

In twelve Budgets and twelve MYEFO rounds I saw any number of Ministers who thought they could single-handedly win an election if only we would advance them a few billion here or there. A few billion might not make an overall difference to the Budget but once it gets around that someone is getting additional billions there will be no end of others wanting similar treatment.

Discipline can only be maintained if it applies to all. After a while spending Ministers figure out that they have an overwhelming majority in the Cabinet and can easily out-vote the Treasurer and Finance Minister if they all band together. That's why, in my experience, discipline inevitably wears down over the life of a Government.

The best Cabinet I was in was the first. The people there had gone through a hard period of Opposition. They had won their positions on merit. As the years went by people started coming into the Cabinet who had not gone through Opposition. Promotion came much more through the Leader's preferment. Getting such preferment is a skill of its own but a different skill to proving yourself in Opposition against a Government.

The determination to balance the Budget and keep it in balance proved of enormous benefit in maintaining discipline. We could truthfully tell Ministers that their proposals were not affordable. They were not affordable if we were to balance the Budget. Of course, if we had been prepared to run \$20, \$30, or \$40 billion deficits they would have been quite affordable. The balanced Budget target gave the Coalition enormous discipline.

Political Outcomes

Of course, the decision to balance the Budget not only created direction for the Government, it created a challenge for the Opposition. They opposed spending cuts. How could they do that and support a Balanced Budget? Did they support a Balanced Budget?

Before the 1996 election, PM Keating moved Kim Beazley into Finance – a domestic portfolio – to toughen him up and give him the kind of experience which he would need as a leader later on. Of course, Beazley did become the Leader but the Finance experience – far from being a proving ground – became a millstone around his neck. My view is that the disaster of 'the Black Hole' killed Beazley not just in 1998 but also in the 2001 election. He could never convince the public he could be trusted with finances.

In 2004, John Howard was genuinely unsettled by Latham. Latham had baggage but it was personal, not economic. An indication of how worried Howard became can be seen in the promises he made during the 2004 election campaign. They were too expensive. Howard said to me afterwards "I wasn't going to die wondering". By this time Budget discipline was beginning to fray at the top. The economy was picking up which made it harder to run tough expenditure restraint. The existential threat of a Budget deficit was receding.

Of course, the fraying of discipline at the tail end of the Howard Government was nothing compared to what was to come after.

The Reward for Good Policy

Of course, with all this belt-tightening and cost cutting, the public wants to know there will be some ultimate gain – something to show for it. In our case, we held out the prospect that interest rates would be lower as the Government reduced its call on capital markets and began to add to saving. In fact, this proved to be the case as interest rates were lowered through the late 90s. They started rising again in anticipation of GST, but once we got through that, they came down again.

The other prospect we held out, was that once debt was lowered (preferably eliminated) we didn't need as much tax, and people could share the bonus of good policy by paying less of their earnings to the Government. That was why tax cuts were so important. It was the Government delivering its side of the compact after years of restraint undertaken by the public.

The longer-term point was that good fiscal policy was strengthening the Commonwealth Balance Sheet. We had two credit upgrades to AAA. A strong Balance Sheet would prepare us for the ageing of the population. No comparable country strengthened its balance sheet through this period in the way Australia did, not Britain, the U.S., Canada, not in Europe.

As it turned out, the strong Balance Sheet and AAA rating stood us in very good stead when another challenge came along – the 2008 financial crisis. We were better placed than any comparable country to deal with it.

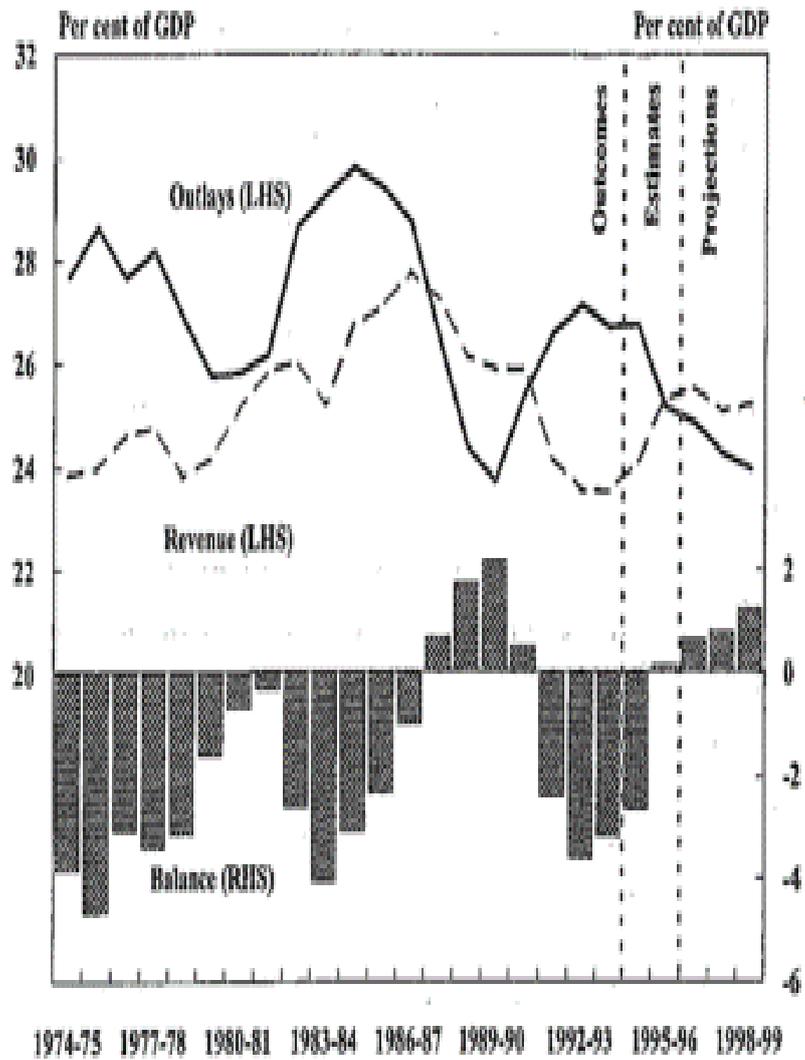
Of course, the spending that started in 2008 never really stopped. The debt that was paid off between 1996-2007 has all been re-borrowed. People often ask whether it was worth paying off the debt given that subsequent Governments have gone out and borrowed it all back.

The only answer I can give is to say: - just imagine where we would be if we hadn't paid off that debt. Sure, subsequent Governments have piled on debt, but if we hadn't got the Commonwealth debt free, they would have piled debt on pre-existing debt rather than debt against a strong asset position.

Even today Australian Government net debt is much lower than comparable companies. Our fiscal journey over the last ten years has been bad. But our starting point was extremely strong. It was the starting point that gave us the ability to weather the 2008 storm.

Annexure A

CHART 1: BUDGET AGGREGATES



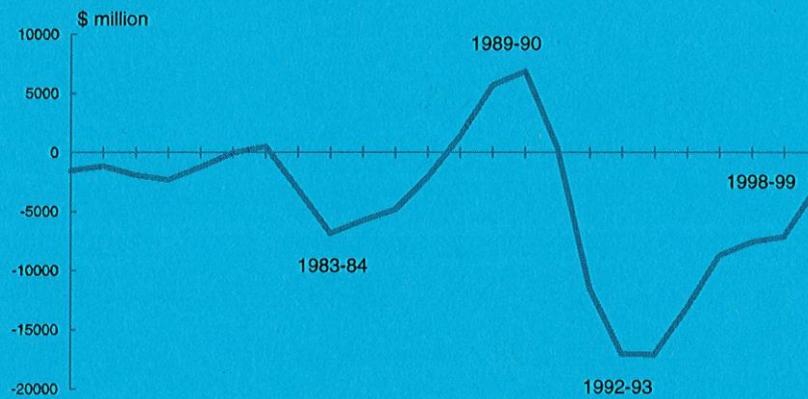
Source: Budget Paper No. 1 1995-96

Annexure B



THE TREASURY

Post 1996 Federal Election Briefing



2 March 1996

Briefing Folder No.

1