'In 1996, the mood for change was palpable ... anyone you spoke to, every time you turned on a television, radio or opened a newspaper – the nation wanted change ...'

Dr Brendan Nelson AO

The Ascent to Power, 1996 takes a critical look at the Howard Government's rise to power; its policies and priorities, successes and shortcomings in what Paul Kelly calls the 'foundational year'.

This first of four volumes on the Howard Government's nearly 12 years in office draws on unpublished documents from John Howard's papers held at UNSW Canberra. It covers the 1996 election, relationships with the Australian Public Service and Senate crossbenchers, reversing the budget 'black hole' and gun law reform following the Port Arthur massacre.

With contributions from John Howard, other politicians, media commentators, key public servants and academics, *The Ascent to Power, 1996* will inform future assessments of the Howard Government and its place in Australian history.

UNSW PRESS

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EDITED BY TOM FRAME

THE ASCENT TO POWER, 1996

THE HOWARD GOVERNMENT
VOLUME I

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FORGACS MARINE AND DEFENCE

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9

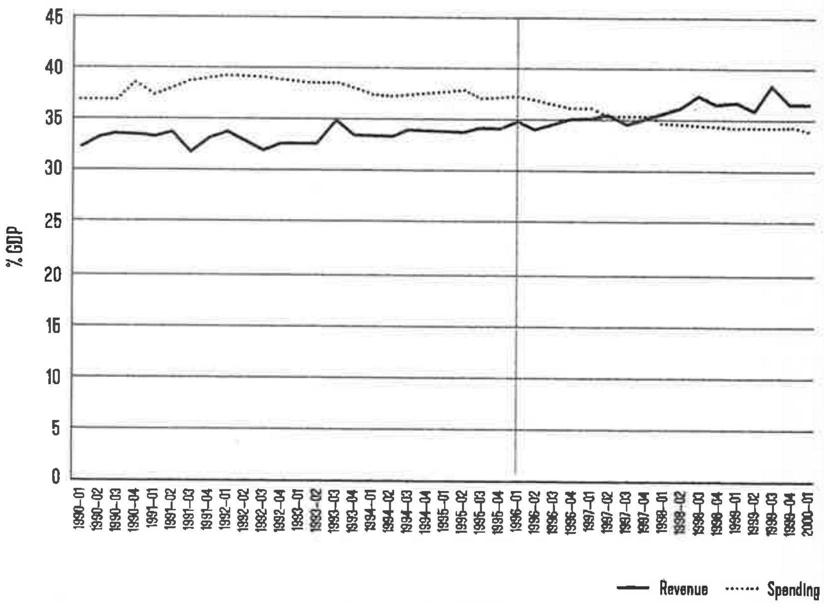
ECONOMIC MANAGEMENT

WARWICK McKIBBIN

An evaluation of the Howard Government's economic management during its first year in office needs to extend beyond 1996. An accurate assessment of the Australian economy must take account of both the historical context and subsequent responses to policy changes. From an economic point of view, policy changes implemented in one year can have enduring ramifications. For example, consider the budget deficit revealed by treasury after the Coalition won government. The debate on this 'black hole' implied that there was no future funding to cover the gap between outlays and revenue. Figure 1 (page 142) shows Australian Government outlays and revenue from the years 1990 to 2000. A deficit is clearly apparent leading into 1996. Without any policy changes, and assuming that the future would be like the past, it is reasonable to conclude that funding was inadequate in later years. However, it is difficult to determine why the deficit disappeared in future years, since the outcome for the fiscal deficit after 1996 also reflected the policy changes implemented by the Howard Government.

Compared with the current fiscal deficits, and the rising share of government spending in Australia's Gross Domestic Product (GDP), this period of successful fiscal adjustment appears to be

FIGURE 1 Australian general government outlays and revenues



SOURCE OECD Economic Outlook Database No 99, June 2016.

an historical blip. If Figure 1 was plotted out to 2016, the 'black hole' would be difficult to see; compared with the current position, the 1996 budget deficit is better termed a 'pothole'. This does not mean, however, that 1996 was an unimportant year. In fact, it was a significant year for good economic policy in Australia with important lessons for the Australian economy in 2017. The issue of fiscal adjustment and economic reform which was big in 1996, is even bigger in 2017.

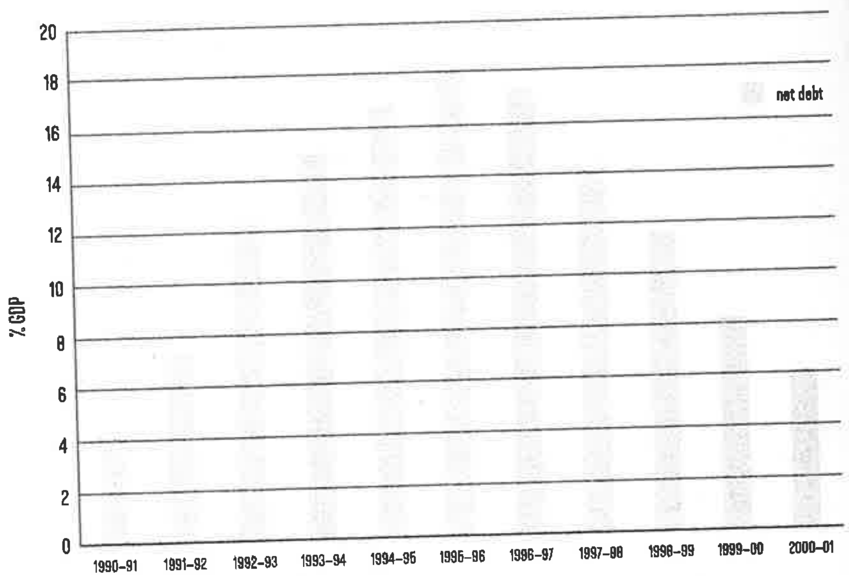
In important ways, the Australian economy is still experiencing the economic legacies of the three key economic policy changes introduced early in the Howard Government. The first is the fiscal goal of balancing the Budget over the economic cycle. The goal was never to accumulate large fiscal surpluses, but to

implement a conservative and sensible fiscal policy while avoiding the accumulation of public debt. The second major change was to formalise the independence of the Reserve Bank of Australia (RBA) and put in place a realistic inflation goal. The third change was securing the passage through federal parliament of the *Workplace Relations Act 1996* and a series of other labour reforms to replace Award Wages with Enterprise Bargaining. These innovations significantly increased the capacity of the Australian economy to absorb economic shocks. It is always difficult to plan for unknowns; policymakers did not imagine and could not reasonably predict the global transformations of the following decades. But reforms initiated in 1996 made the Australian economy more flexible and resilient. The sale of government-owned assets created a revenue source to help with the fiscal goal, but this also led to improved performance among some important enterprises. Asset sales, together with subsequent waterfront reform, made Australia more efficient and more productive.

Many of these economic changes were so deep and so fundamental to the Australian economy that commentators would not expect them to have an impact straight away. So while the costs were paid up-front, the benefits would come much later. This makes them a courageous set of policies because the economics of long-term benefits do not match the politics of the short-term electoral cycle. The decisions did not have to be made; the government was not forced into reform. Notably, these decisions built on reforms initiated by the Hawke and Keating governments that also had long-term implications. Because the Coalition was the beneficiary of Labor policies, it is hard to untangle their relative contributions or to apportion credit and blame for the state of the economy in 1996. But in the decade from 1996 large economic returns flowed from a series of politically difficult decisions. Given, regrettably, that there is much rewriting of history, we need a more rigorous econometric analysis of the impact of the 1996 policy changes. I am not attempting to be definitive but to provide data to inform the debate.

Figure 1 shows that from the first quarter of 1990 to the first quarter of 1996, government outlays were persistently above revenue. The difference between these (the gap in the table) is the budget deficit. The Labor Government had taken policy decisions to reduce the gap in 1995–1996 but there was a distinctly larger shift after the 1996 election. Spending trended down and revenue continued to rise. The implications of the 1996 policy changes on fiscal outcomes are clearer in Figure 2. This figure shows the net central government debt. The adjustment in the flows of revenue and spending clearly indicate a change in the scale of government

FIGURE 2 **Australian net central government debt**



SOURCE Mid-Year Economic and Fiscal Outlook 2014–15, Table D6, p. 273.

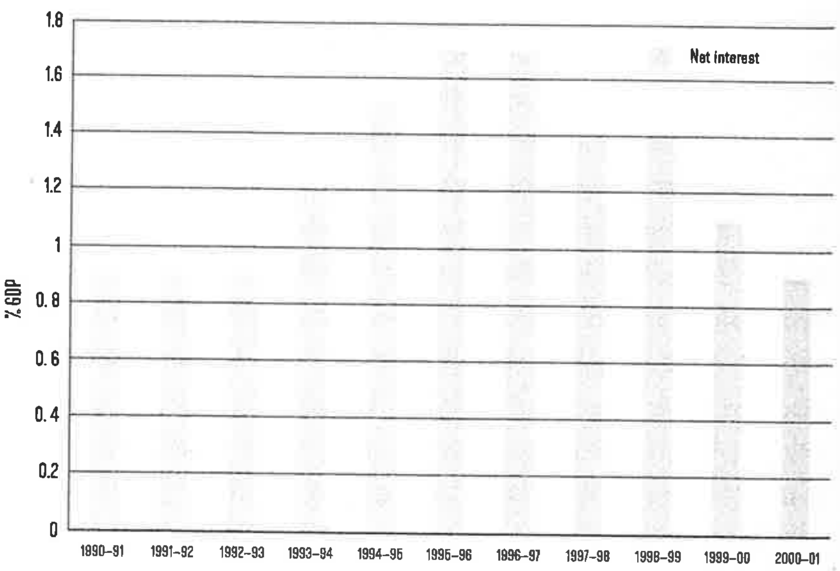
debt after 1996. Although the trend in the share of government spending in the economy continued to fall until 2000, this was later reversed. The share of the public sector in GDP reversed the hard-won decline in the first years of the Howard Government.

The rise in revenue was largely due to higher tax revenue caused by fiscal drag. Although the Howard Government was successful in closing the gap between spending and revenue, the tax system itself could have been reformed more quickly and more substantially. John Howard had a track record of proposing tax reform but the politics had prevented major change. The introduction of the Goods and Services Tax (GST) in 2000 was hugely significant. It can be argued that the ability to introduce the GST in 2000 was possible because of the early changes in the fiscal position from 1996 which closed the budget deficit. In 1996, the debate about the size of the budget deficit and the need for revenue increases and spending cuts was the major issue. Today, the debate about tax reform is still focused on the large gap between spending and revenue. Even more so than in 1996, however, there needs to be a change in the mix of taxes away from income-based taxes towards consumption taxes like the GST.

Figure 3 (page 146) shows the benefits flowing from reducing government debt by running a series of budget surpluses. This figure presents net central government interest payments. From 1996, there were falls in both the stock of debt as well as the interest rate on that debt. Thus, less government revenue was used to pay interest, and this could be used to fund government services or to cut taxes.

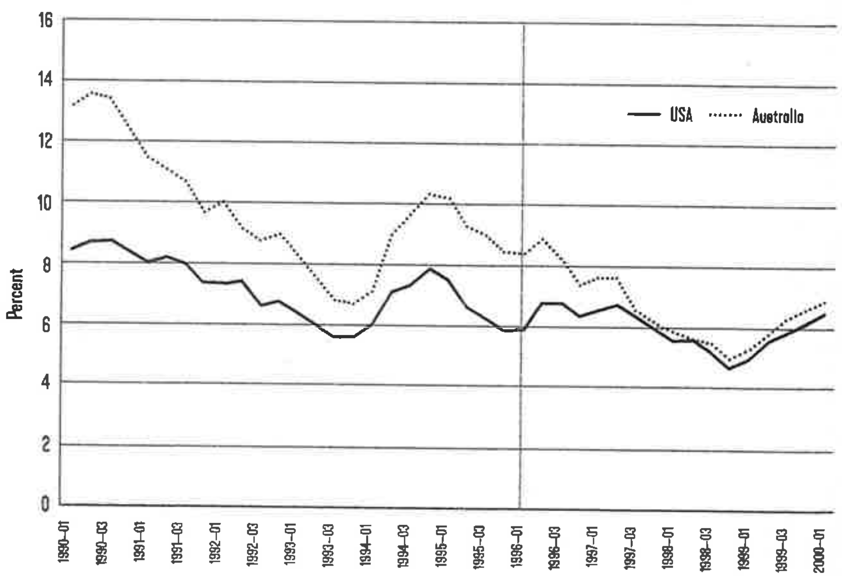
Figure 4 (page 146) shows Australian versus American interest rates on 10-year bonds. The persistent gap between Australian and American long-term interest rates reflects different inflation rates in the two countries, an expectation of exchange rate changes and,

FIGURE 3 Australian net central government interest payments



SOURCE Mid-Year Economic and Fiscal Outlook 2014–15, Table D6, p. 273.

FIGURE 4 Australian and US 10-year bond rates



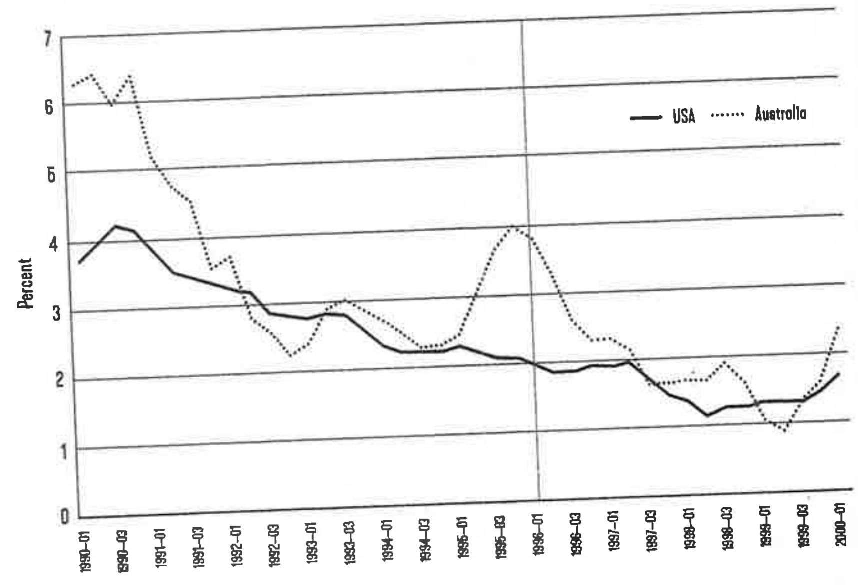
SOURCE OECD Economic Outlook Database No 99, June 2016.

most importantly, Australia's sovereign risk. This gap was persistently positive until 1996. After the fiscal adjustment applied by the Howard Government, the gap closed. As a result the cost of borrowing on the world markets fell significantly for the Australian Government as well as Australian companies.

Australia has been a net recipient of capital from overseas throughout its European history. The Australian economy does not have enough savings to invest in the range of opportunities available. Therefore it makes sense for Australia to borrow or issue equity overseas. The more the government accumulates debt the more Australians have to pay for private sector access to capital. The Howard Government's deficit policy aimed to reduce the amount of government payments in terms of foregone interest while increasing Australian access to cheaper capital on the world market. The combined effect was an expansion of the private sector. The reduction in government debt also provided a crucial buffer that was useful as a response to future negative shocks. When this decision was taken, no one knew that there would be an Asian financial crisis in 1997–1998. There were certainly no predictions of the 2001 collapse in the American 'tech boom' or the global financial crisis from 2008 to 2010. The prudent fiscal policy of the early Howard years produced a vital financial cushion for a small open economy whose income was highly dependent on the value of commodities. And while a good fiscal position was essential from a risk management point of view, fiscal prudence also made tax reform a real possibility.

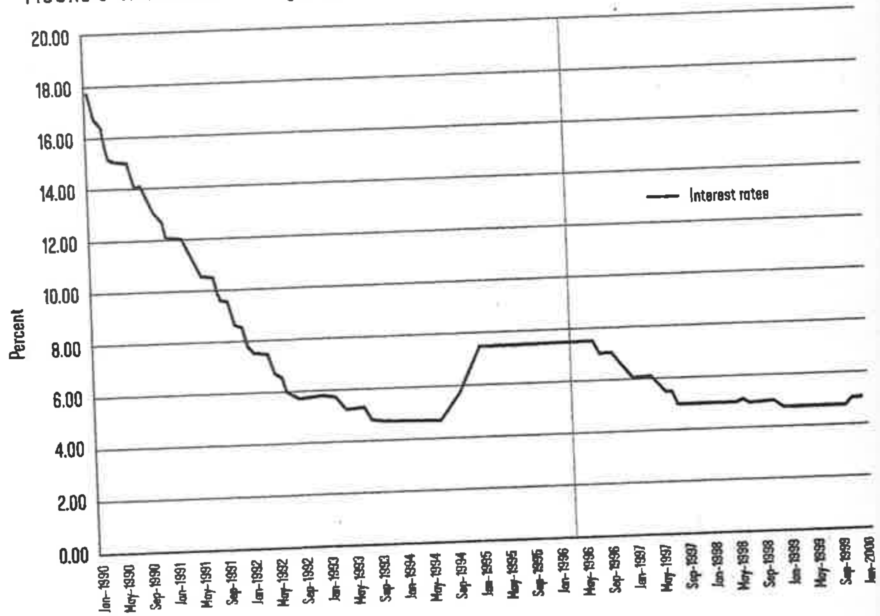
Another significant contribution of the Howard Government to economic prosperity was continuing support for the independence of the Reserve Bank of Australia (RBA). Figure 5 (page 148) shows core inflation in Australia relative to the United States. While the recession of the early 1990s – the 'recession we had to

FIGURE 5 Australian and US core inflation



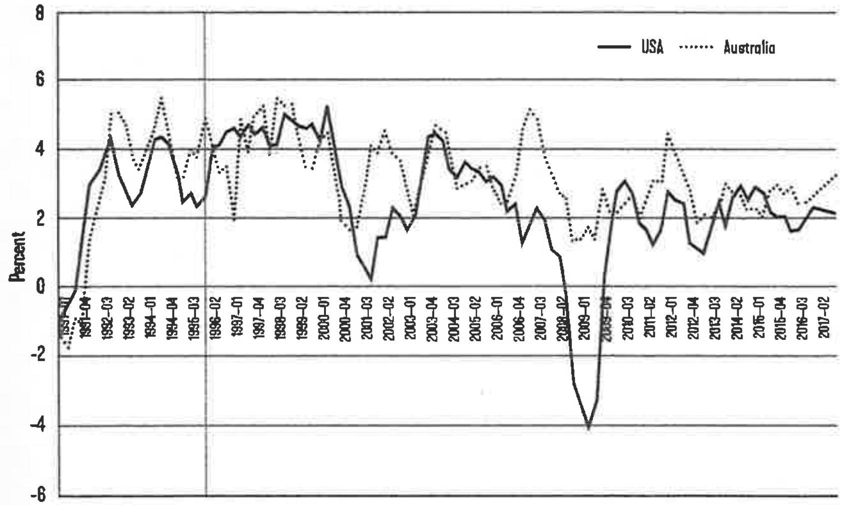
SOURCE OECD Economic Outlook Database No 99, June 2016.

FIGURE 6 Australian overnight cash rate



SOURCE RBA online database Table F1.1 INTEREST RATES AND YIELDS – MONEY MARKET, downloaded.

FIGURE 7 Australian and US real GDP growth



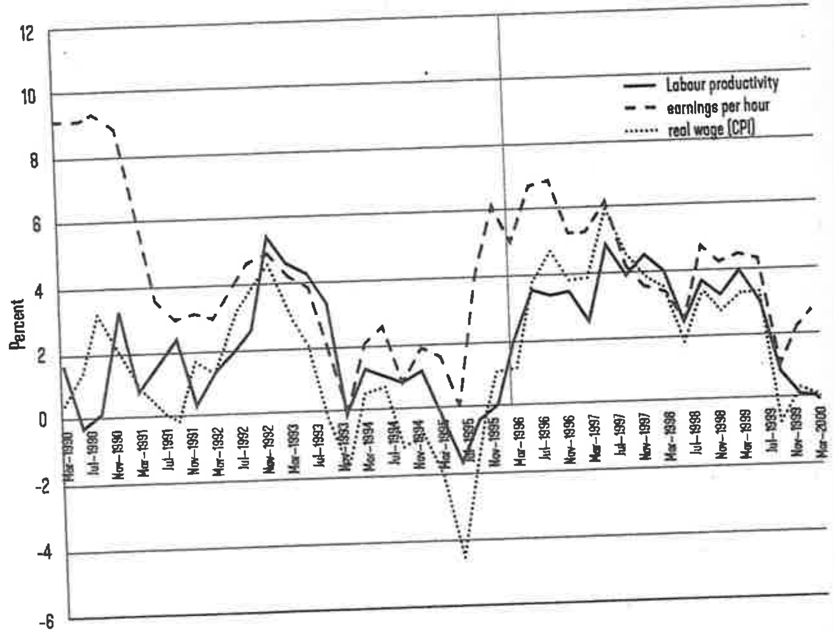
SOURCE OECD Economic Outlook Database No 99, June 2016.

have' according to Paul Keating – reduced inflation in Australia to a level comparable with that of the United States, there was an appreciable difference in rates from late 1994. The rise in inflation within the Australian economy was successfully truncated, partly due to the independence of the RBA as well as the Howard Government's fiscal policy. Inflationary expectations were recalibrated the following year. Lower inflation and reduced government debt enabled the RBA to return to lower interest rates after 1996 (Figure 6).

Figure 7 shows real GDP growth from 1990 to 2017 for both Australia and the United States. This data shows that during the 1990s, Australia did not deviate too much from the pattern of American growth, although Australian economic growth was more volatile and less predictable. After the Howard Government's election, Australia's growth rate clearly fell below the American growth rate for a short period. This reflects the short-term economic cost of introducing reforms that led to benefits over the next decade. After the reforms, Australian GDP growth was consistently higher than American GDP growth. This meant that the Australian economy was able to avoid a number of sharp global recessions in the years that followed. The Howard years show us how economic reform decisions that were costly in the short term may have substantial economic benefits over time. This has been the Australian experience.

Figure 8 shows another indicator of economic performance. This table tracks labour productivity (output per hours worked), earnings per hour and the real wage defined relative to the con-

FIGURE 8 Australian labour productivity, earnings, real wages (year ended per cent change)

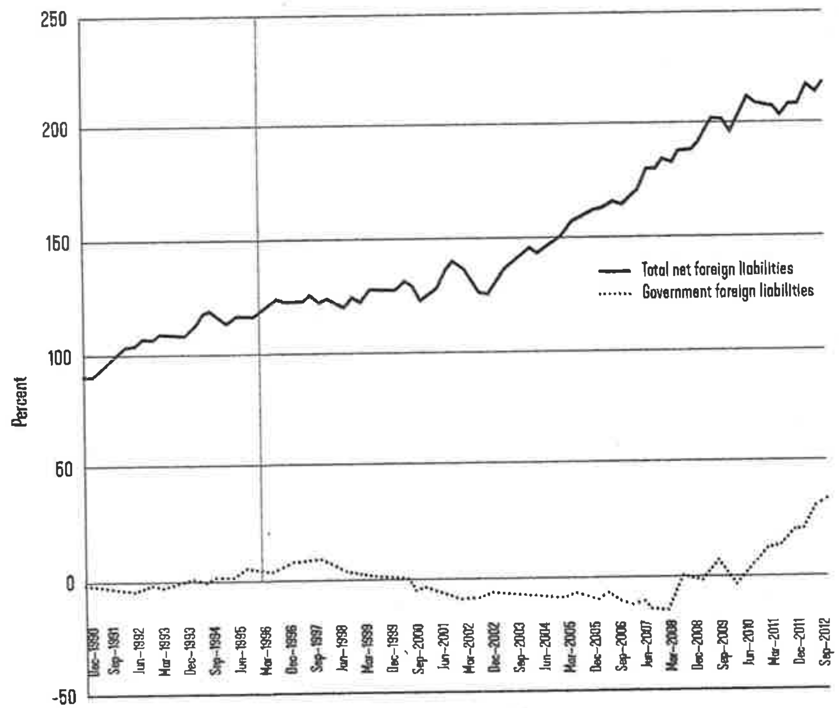


SOURCE: RBA online database Table H4 Labour Costs and Productivity, downloaded November 2016.

sumer price index. Its message is that disinflation in the early 1990s led to a substantial decline in the nominal wage. Disinflation refers to a slowing in the rate of price inflation over the short term. Although used to describe slowing inflation, disinflation should not be confused with deflation, which can be harmful to the economy. Between 1993 and 1995 real wages and productivity fell very sharply. A period of strong productivity growth followed the reforms initiated by the Howard Government which led to strong real wages growth. Labour market reform was a necessary component of Australia's reform success. Policies introduced by the previous Labor Government were generating benefits by the time the Coalition won office in 1996. The Howard Government's reforms added impetus and increased the benefits. Finally, one of the spurious arguments during the 1996 election was that Australia was borrowing too much from the rest of the world as evidenced by the current account deficit. As I have explained, Australia must attract foreign capital if the economy is to grow since its economic opportunities are greater than its capacity to generate investment capital. Hence, it needs to source international funds.

Figure 9 (page 152) shows Australia's net foreign liabilities as a whole and the amount generated by government. Net foreign liabilities were rising quickly before 1996. After the election of the Howard Government it is clear that foreign borrowing levelled off. When the government contracted the budget deficit (given there was a lagging effect), it stopped borrowing so much from overseas. The government was essentially reducing its overall borrowing which enabled the private sector to expand its borrowing and eventually prepare for the China boom after 2002. The idea that Australia was running a current account deficit and that this was 'a bad thing' has always been problematic in political discourse and it remains a political issue. It is not bad for Australia to borrow or to

FIGURE 9 Australia's net foreign liabilities



SOURCE RBA online database Table F5: Australia's Net Foreign Liabilities, downloaded November 2016.

raise equity to invest in assets and activities that raise its productivity. So there is 'productive' borrowing and 'unproductive' borrowing, depending on how the funds are used. From 1996 the Howard Government succeeded in reducing government debt within the Australian economy and withdrawing from foreign bond markets. This occurred without the current account going into perpetual surplus. While the electorate thinks surpluses are always and everywhere good, a current account surplus in this instance would have been a bad outcome that suggested less Australian investment relative to Australian savings. The subsequent current account

deficit after 2000 reflects the strength of the Australian economy in attracting foreign capital, which was a positive outcome.

In sum, there are many lessons for the contemporary economic debate in Australia to draw from the economic experience of the first year of the Howard Government. Bringing the fiscal position into balance was clearly a key contribution to national prosperity though its full benefit did not come within the Coalition's first term in office, but over many years. Indeed, Australians are continuing to experience the benefits. The transformative decisions to consolidate financial institutions and codify the RBA's independence created a new economic environment that subsequent governments have not sought to dismantle or disturb. In addition to strengthening the RBA's independence, an appropriate fiscal–monetary policy mix set up the Australian economy for strong and protracted growth. The pay-off took time and the investment of political capital. Some of the decisions were either misunderstood or poorly understood and the electorate was anxious. But labour market reforms allowed real wages to rise and productivity to grow.

Finally, scaling back the extent of government borrowing, particularly borrowing for current consumption purposes or transfer payments, enabled the expansion of private sector borrowing through the balance of payments. Some critiques of the Howard Government's economic performance make much of the current account not going into surplus, arguing that its policies were a sign of failure. It was, in fact, quite the opposite. It was a sign of success and a deliberate policy decision. Australian corporations and households could borrow overseas at a lower cost than would have been the case had the government dominated the domestic bond market.

The Howard Government's first year continues to provide relevant lessons. We learn from 1996 that economic reform is difficult and can be costly in the short term with the likelihood of unintended consequences. But the pay-off is substantial: a more flexible economy and stronger institutions. These reforms raised national income and created a more resilient economy. Low government debt and controlled government spending also gave policymakers a greater capacity to respond to external shocks and domestic pressures. Two decades on, when some of these lessons appear to have been forgotten, the consequences are not difficult to discern.

10

A VISION FOR GOVERNMENT

MICHAEL L'ESTRANGE

Any analysis of a 'vision for government' is not an exact science. It can be interpreted very differently by those who developed the vision, by those who contested it at the time, by analysts of the process and by interested observers. This is particularly the case when a 'vision for government' is re-assessed more than two decades on from the time it was presented. The Coalition vision for government in the lead-up to and following the 1996 Federal Election was not based on philosophical theorising, or grand utopian concepts, or a frenetic agenda for the 'first one hundred days'. Still less was it a vision focused on the pursuit of rigid ideology or doctrine. The Coalition's vision for government in 1996 had very different guiding lights. It had practicality and common sense as its watchwords and it had the instincts aspirations of the mainstream of Australian society as its driving force.

At the heart of this vision lay the strategic priorities that the Coalition articulated and the political values it championed. Those strategic priorities were economic reform, social stability and a confidence drawn from Australia's past achievements and future potential. And the political values that drove the vision for