



Australian Federal  
Government deficits,  
debt and the stock  
market



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## Introduction

While the media coverage surrounding the budget is full of facts, figures and opinions, much of the debate is clouded by political rhetoric and misinformation. Here we stick to the facts. This paper puts the current budget into context and considers what budget deficits mean for investors. In particular:

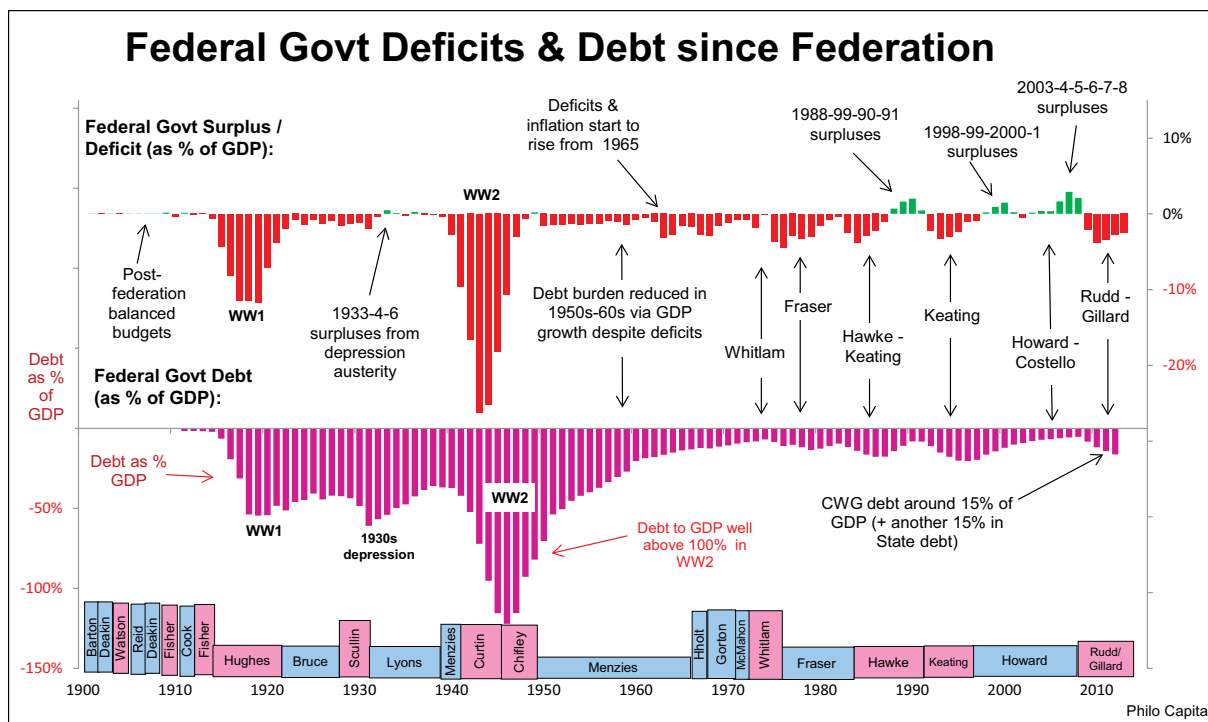
- How often have governments produced budget surpluses?
- How do Labor and Liberal governments compare when it comes to deficits and debt?
- How serious are the current levels of deficit and debt?
- Have government deficits been good or bad for stock markets?

## History of Federal Government Surpluses, Deficits and Debt

Our first chart shows the history of federal government fiscal balances and debt levels since Federation, and it also shows the various governments in power. Labor governments are shown in pink and “right leaning” governments in blue. (I have categorized the Liberal and National/Country Parties, together with the United Australia Party, Protectionist, Fusion, and Free Trade parties as “right leaning” for the purposes of this discussion).

Our intention here is not to make political comment that one approach is better than the other but rather to use historical observations to highlight potential impacts for investors.

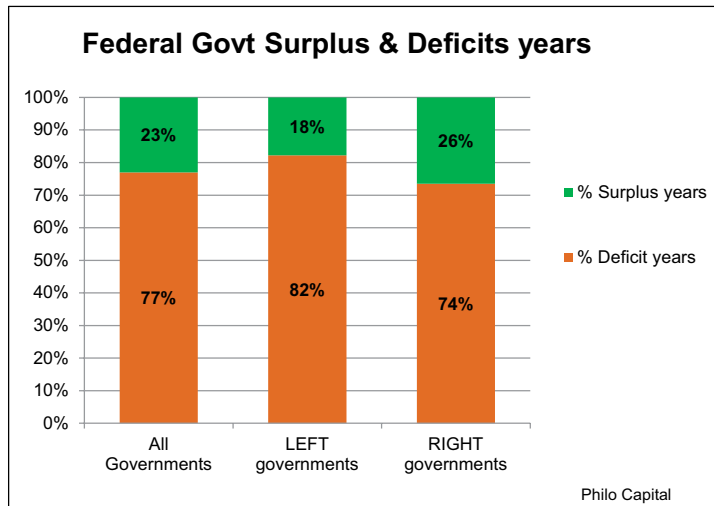
Chart 1: Federal Government Deficits & Debt since federation



The top section shows the annual government balance (surplus or deficit) expressed as a percentage of GDP (June years). We can see that governments have run surpluses (green bars in the top section) in only a very small minority of years.

Chart 2 shows that Labor governments have achieved government surpluses in 18% of all years they have been in power, while right leaning governments have achieved surpluses in 26% of years in power.

Chart 2: Surplus/Deficit years

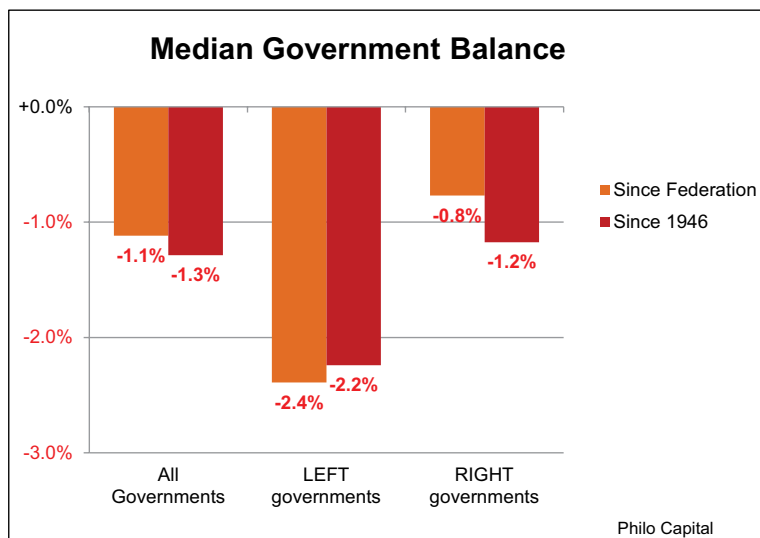


Surplus years have been few and far between. Aside from the early years of balanced budgets (before Canberra existed!), the only surplus budget outcomes have been the following:

- 1933, 1934 & 1936 - resulting from the depression austerity plan under Joe Lyons (UAP)
- 1949 (just) under Chifley (Labour)
- 1988-9-90-91 under Hawke/Keating prior to the deficit spending in the 1990-1 recession
- 1998-99-2000-1 under Howard/Costello - prior to the “tech wreck” slowdown
- 2003-4-5-6-7-8 under Howard/Costello (although Kevin Rudd took power during the 2008 fiscal year)

Chart 3 shows that on average Labor have tended to run larger deficits. Even if we just look at the post-war era the differences are still significant, and reflect the philosophical differences between the major parties over the role of government in the economy.

Chart 3: Median government balance since federation (as percentage of GDP)



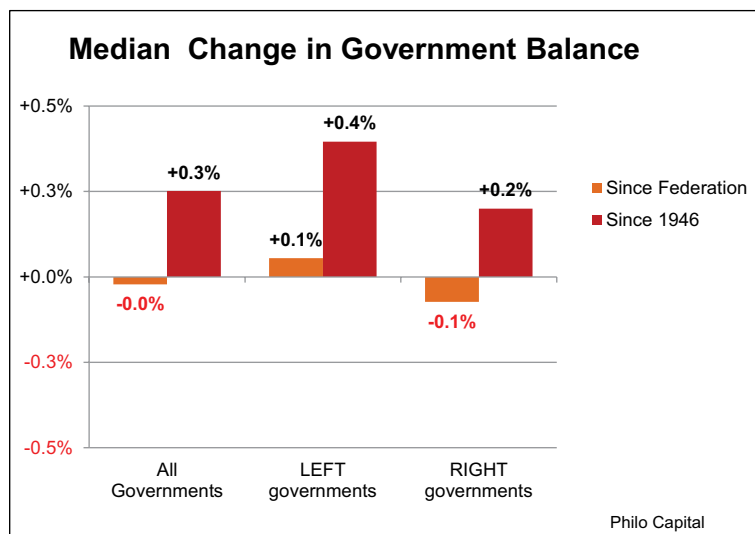
### Changes in government fiscal balance

More important than the actual level of government fiscal balance from year to year is the change in the balance. This is the case for a couple of reasons. The first is that every government inherits the budget position from the last government and so it has more control over changes in government spending and revenues than it has over the levels of spending and revenues themselves.

The second reason is that is the change in balance rather than the level that reflect the incumbent government’s fiscal stance and its effects on the economy. For example if a government goes from a deficit of \$40b in one year to a deficit of “only” \$10b in the next year, the \$30b in lower spending and/or higher taxes in the second year represents a substantial tightening of fiscal policy even though the deficit in the second year appears expansionary if viewed in isolation.

Chart 4 shows that left wing governments have a slightly better record of reducing deficits over the whole period and also in the post-war period, although in most cases it was reducing their own deficits, since Labor governments ran larger deficits overall.

Chart 4: Median change in government balance (as percentage of GDP)



## History of Federal Government Debt

The lower section of chart 1 shows the cumulative Commonwealth debt balance over time since Federation. We can see that main debt build-ups were caused by the massive deficit spending efforts in the two World Wars.

The debt-to-GDP ratio also increased in the 1930s depression, but it was not due to deficit spending. Between 1929 and 1932 the level of debt was actually reduced by 15% but nominal GDP contracted by a staggering 31% (half of which was due to a real GDP contraction and the other half was through price deflation).

Australia did not follow a Keynesian deficit spending spree like the US because we simply were not able to. The commonwealth and state governments had run out of credit in foreign debt markets by 1929, and the government's then wholly-owned Commonwealth Bank refused to lend it more money. So the only option was to stick to the savage and deflationary austerity of the 1931 "Premier's Plan" and force all holders of domestic government debt into a 22.5% haircut restructure deal. (This is the current "plan A" for the PIIGS in Europe today.)

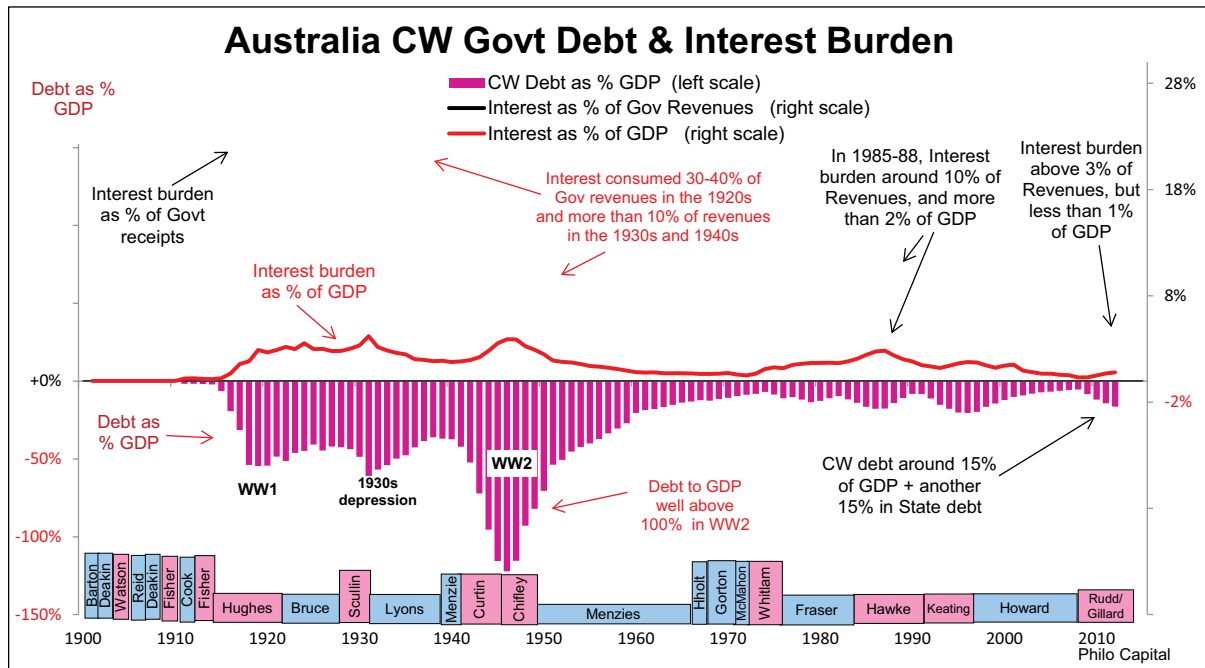
The austerity and interest savings from the debt restructure resulted in three government surpluses - in 1933, 1934 and 1936. These were achieved under Joe Lyons' new United Australia Party, out of which Bob Menzies created the current Liberal Party. (I have labelled the UAP as being "right leaning" even though Lyons and much of the cabinet and members had defected from Jim Scullin's Labor party).

## Current level of federal deficits and debt

Chart 1 also shows that the current Rudd/Gillard deficits are similar in scale to the Fraser, Hawke and Keating deficit eras. Contrary to popular myth the Whitlam era was not one of high deficits or high debt (the only significant deficit was in 1975, with the budget crisis triggering the controversial change in government).

The next chart shows the interest burden of the government debt - expressed in terms of interest cost as a percentage of GDP and also interest cost as a percentage of government receipts (mainly tax revenues).

Chart 5: Federal government debt and interest burden



The first thing that stands out is the fact that interest on government debt consumed 30-40% of all government revenues in the 1920s (on a par with the PIIGS and Japan today) and it was still consuming more than 10% of revenues in the 1930s and 1940s (on a par with the US today). The interest burden was then brought down in the post-war boom in the 1950s and 1960s.

In recent years the interest burden of government debt was at its lowest level ever in 2007-8 (when the level of debt was also at its lowest level) but interest costs have risen sharply as the debt level has risen since 2008.

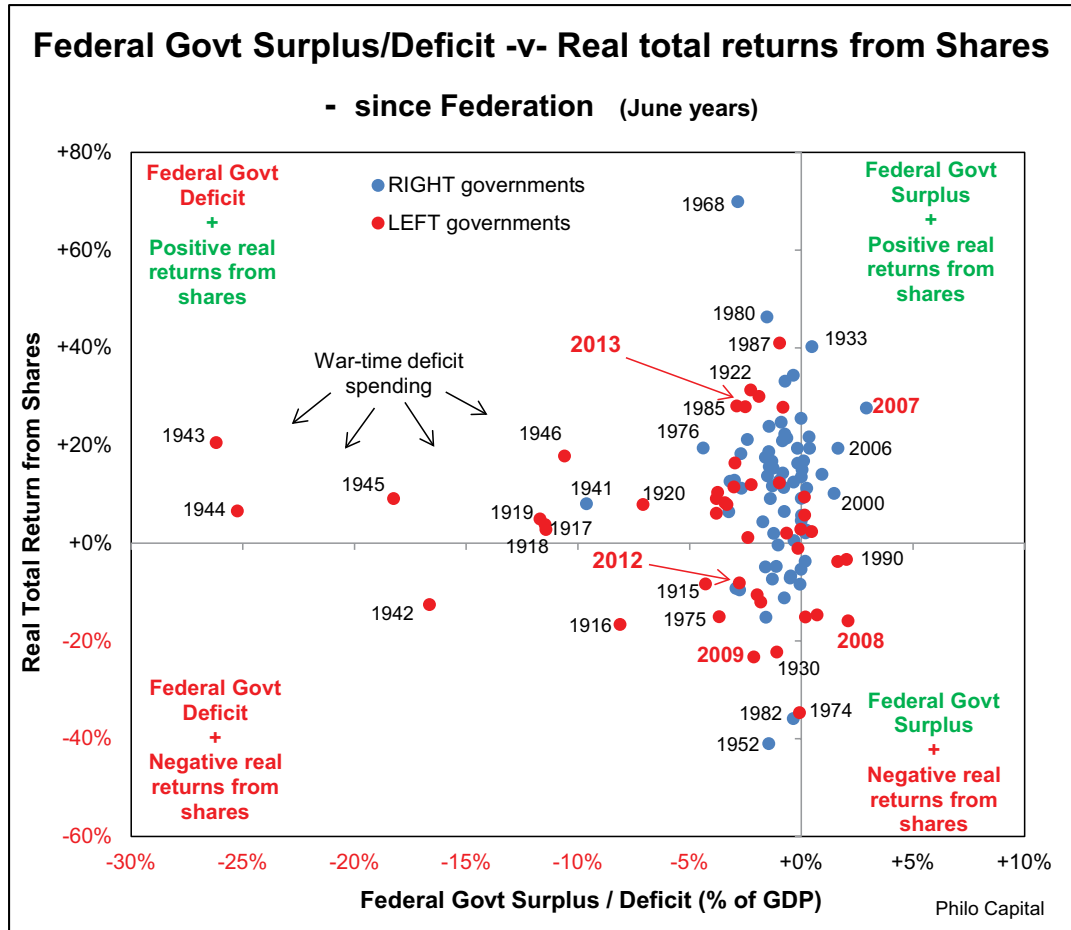
However, the current interest burden (at less than 1% of GDP and around 3-4% of tax receipts) is no higher now than it was in the 1950s to the 1970s. This is partly due to the relatively low level of debt, and also partly due to the relatively low interest rates today.

## Deficits and stock market returns

But what does all of this mean for investors?

Chart 6 shows the annual federal government balance plotted against real total returns from shares (ie including re-invested dividends and after CPI inflation). These are years ending in June to line up with the fiscal years. Labor government years are shown in red and right leaning government years are shown in blue.

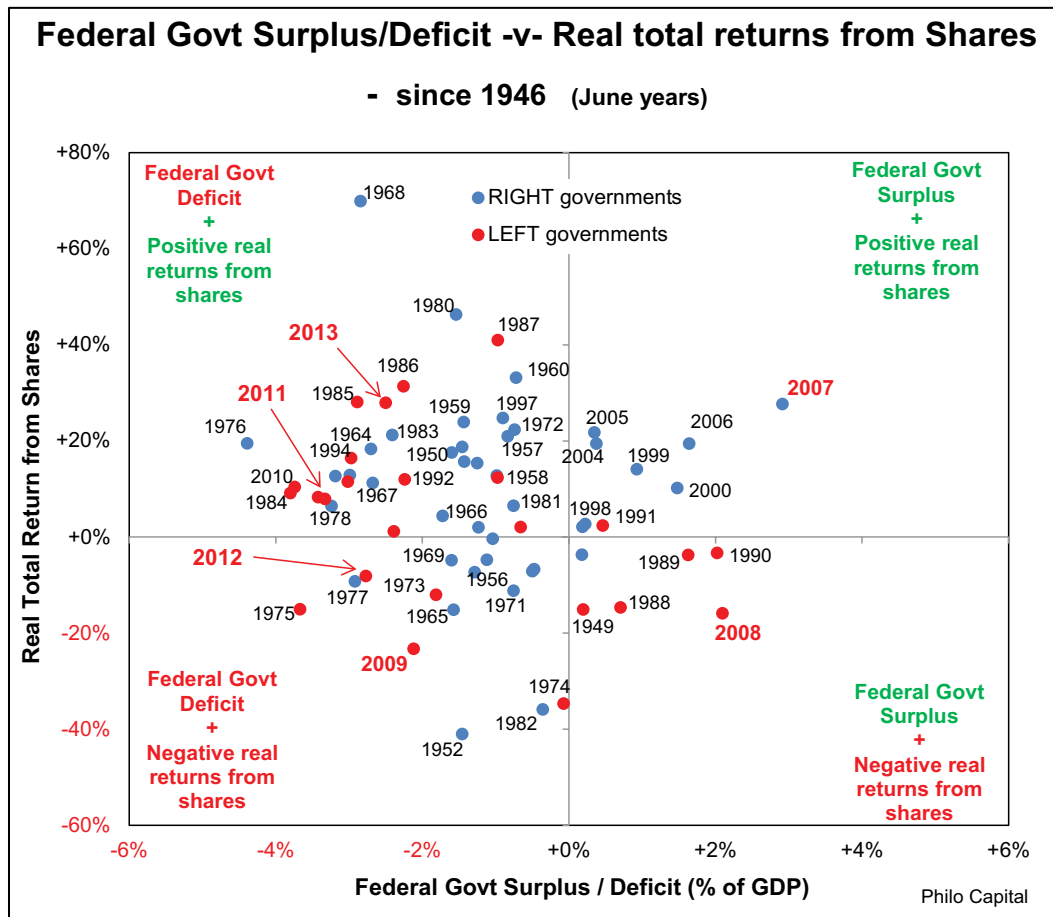
Chart 6: Federal government surplus/deficit -v- real total returns from shares - since Federation



Clearly the war-time years at the left of the chart dominate the overall picture - with very large deficits but also good stock market returns in most years (although returns during WW2 were somewhat affected by war-time limits on share price movements).

Chart 7 shows the same story but for post-war years only.

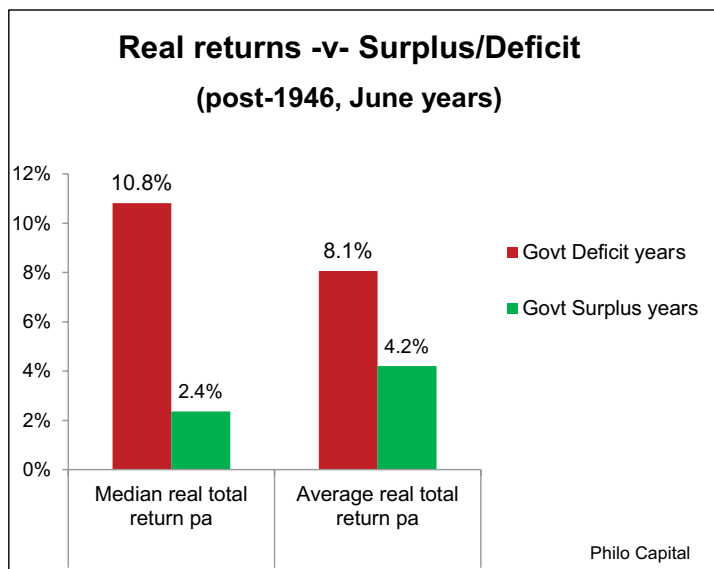
Chart 7: Federal government surplus/deficit -v- real total returns from shares - post 1946



There has been a mildly negative correlation between the government balance and stock market returns. Most of the high return years from shares were government deficit years (top left section). This includes 2011 and 2013. (Remember all years are June years in this paper).

Deficits are generally good for shareholders and surpluses are generally bad for shareholders. In the post-war era the median real total return from shares was 10.8% pa in the deficit years but only 2.4% pa in the surplus years, which is a very significant difference. This is seen in Chart 8.

Chart 8: Real returns from shares -v- Government surplus/deficit - post-1946



There are two main reasons for this. The first is that deficits come about by governments spending more money (and/or taxing less), and much of the additional cash ends up in company coffers, either directly via contracting directly to government, or indirectly via household spending.

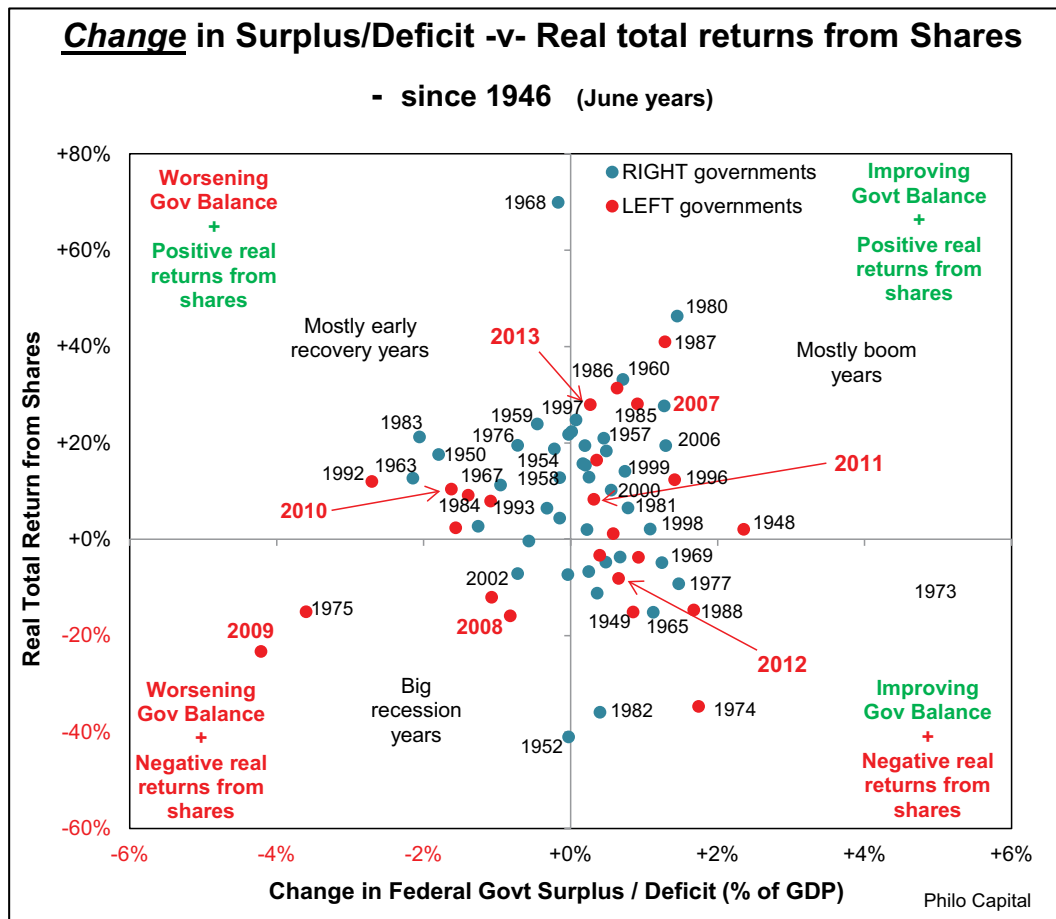


The second reason is one of timing. Deficits tend to be high in mid-late recessions (when tax revenues are down and welfare spending is up), and this is when shares generally do best, rebounding out of the middle of recessions. This was the case in 1954, 1972, 1983, 1992 and 2010, (and in the pre-war years: 1922, 1923 and 1932).

There have been very few years when government surpluses accompanied poor returns from shares (bottom right section). The most obvious instance was 2008, when tax revenues from the boom were still rolling in but shares were already falling in the GFC.

Lastly we look at the relationship between stock market returns and changes in government fiscal balance, since the change in the government balance is a better reflection of the government's fiscal stance and is more controllable by each incumbent government.

Chart 9: Changes in Federal government surplus/deficit -v- real total returns from shares - post 1946

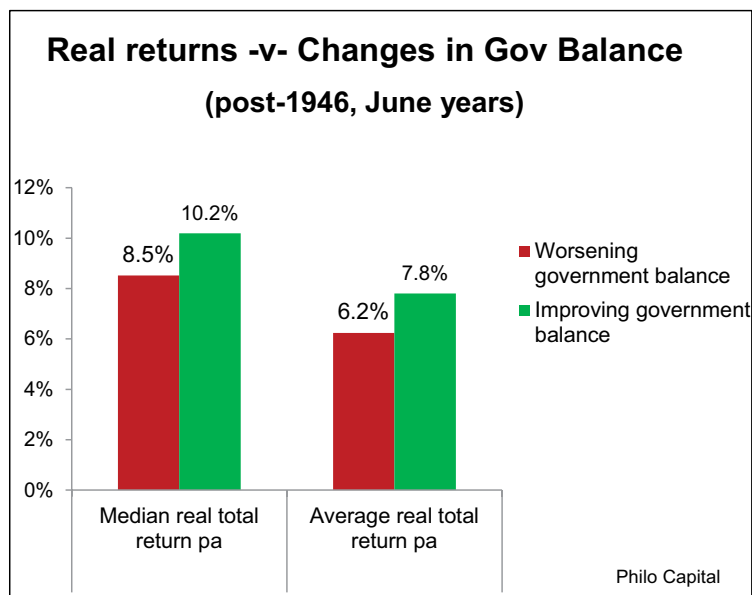


Here we see much less of a clear pattern. In the top left section are years with worsening budget balances but good returns from shares - many of which are early recovery years.

Again the explanation is largely one of timing. Early-mid recessions are generally periods of worsening budget balances and also poor returns from shares. Conversely, early-mid booms are generally periods of improving budget balances and are also generally good for shares.



Chart 10: Real returns from shares -v- Changes in Government surplus/deficit - post-1946



However the differences are not as significant as the stark differences in returns in deficit years versus surplus years (above).

### Some conclusions

We hope that his brief paper adds some factual context to the current highly charged debate.

We can draw some conclusions from these observations:

- Government deficit years have generally been good years for stock market returns. 2013-4 will most probably be a deficit year (as was 2012-3)
- Years of fiscal tightening have been a little better for stock market returns than years of fiscal loosening. 2013-4 will most probably be a year of fiscal tightening (as was 2012-3)
- In the post-war era, Labour has produced four surplus years against the Liberals' eleven. (In the pre-war era, the big debt build-ups in WW1 and WW2 were bi-partisan, but the 1930s surpluses were a result of partisan austerity measures of the UAP (fore-runner to Liberal Party).
- Today's level of government debt is much lower than it was in the two World Wars and in the 1930s depression (although the 1930s debt was primarily the result of 1920's boom-time profligate spending - largely by the NSW state government - and not the result of stimulus spending)
- The current interest burden (at less than 1% of GDP and around 3-4% of tax receipts) is no higher now than it was in the 1950s, 1960s and 1970s.
- The Pre-WW1 period was a golden era of balanced budgets and no Canberra!



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