State of the Regions

2022–2023

The 2nd GFC: The United States Political-Economy and Australia to 2040

SUPPLEMENT REPORT

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Prepared by the
National Institute of Economic and Industry Research
ABN: 72 006 234 626
Lower Ground, Unit 1A, 663 Victoria Street, Abbotsford, Victoria, 3067
Telephone: (03) 9488 8444;   Email: admin@nieir.com.au

Contents

List of tables and figures

Page no.

Tables

Figures

Overview

The following is an extract taken from NIEIR's *State of the Regions 2022-23: Industries, Trade and Occupations in uncertain times* report (https://sor.nieir.com.au).

This report analyses industries and their imports and exports post the COVID period lockdowns, describes the patterns of occupations across regions and investigates regional patterns of wealth and poverty.

Initially, as is traditional in *State of the Regions* reports, Chapter 1 takes a more macro view and investigates the world and Australia's economic growth into the 2030s by developing a base case. The chapter starts conventionally enough by asking the question "*is it justified to declare victory over inflation in either Australia and the United States*?" The lessons from the failed attempts to control inflation from the early 1970s until the severe recessions of the early 1980s and the outcomes over the last three decades, is that victory over inflation can only be declared when, for at least a 12-month period, the following three conditions simultaneously hold; firstly, the unemployment rate is in excess of 5 per cent; secondly, real wages growth equals long-run productivity growth; and thirdly, core inflation growth is not more than 2.5 per cent.

Both countries do not satisfy these conditions. Further, the United States has begun to cut interest rates and Australia, for the 2024-25 fiscal year, had a series of expansionary Government budgets which will maintain the current relatively low unemployment rate. The centre piece was temporary energy price subsidies which will take the headline inflation rate for 2024-25 to approximately 2.5 per cent, but return it to 3.5 to 4.0 per cent for the following year. That is, there is a high risk that monetary authorities would, over 2025, have to reverse course and increase interest rates above mid-2024 levels by between 0.5 and 1.0 percentage points. If a Republican Government is restored in the United States inflationary pressures will be further stoked by tariffs and immigration outflows.

However, the base case takes the view that these inflationary pressures will fade into the background with inflation ending in 2026 from a world recession from interest rate rises caused by a meltdown in United States bond markets forcing a 2nd Global Financial Crisis (GFC). The cause of the 1st GFC in 2008-09 was instability in United States housing markets. The cause of the 2nd GFC will be the inability of the United States to control its Federal public sector deficit, which is currently at 7per cent of Gross Domestic Product (GDP). The Congressional Budget Office (CBO), responsible for monitoring the deficit projects the deficit to remain stable to the early 2030s. However, this is based on implausibly optimistic assumptions and takes no account of the election promises of the two major parties. Once these are taken into account and a more realistic assumption adopted, it is likely that by next year short-term projections of the deficit will approach 10 per cent of GDP.

This will be part of the problem, the other more important part, is that the fiscal footprint of the United States Federal Government is small. Direct (individual plus corporation) Federal taxes are a little over 10 per cent of GDP. This means that to reduce a ten per cent deficit would require a doubling of Federal direct tax rates which, if it was done, in one year would reduce GDP by between 8 and 15 per cent, partly offsetting the direct deficit reduction impact. Soon after the November 2024 election, by the end of 2025 at the latest, investors will realise the situation is intractable and flee the United States bond market, by so doing forcing up interest rates both in the United States and around the world. That is, one day in late 2025 it is assumed enough that bond investors will realise "*that what cannot go on, wont*" and to avoid large capital loss will stop buying bonds and start selling bonds on a large scale. Interest rates will stay elevated until a plausible bi-partisan deal is agreed to bring the deficit under control in the not-too-distant future, probably by 2030 at the latest. Like the 1st GFC, considerable financial damage, financial institution collapse, widespread bankruptcies etc. will have to occur to force agreement.

The 2nd GFC will start irrespective of who wins the 2024 election. A reasonable expectation is that a Trump victory would bring it on earlier. However, the excitement among his media/business base as to the good prospects that now the "*adults are in charge*" would delay it.

World GDP growth is predicted at a reasonable 3.0 per cent for 2025, 0.5 per cent for 2026 and a weak 1.6 per cent for the following year. In 2028 there is a recovery to 2.2 per cent. However, the scaring of the 2nd GFC restricts world GDP growth to an average of 2.3 per cent per annum for the balance of the period to 2040. This is low compared to the historical record, in part because of the low growth prospects for the United States as its deficit comes under, and is held under, control. For Australia GDP growth is 2.0 per cent for 2024-25 and 2.3 for 2025-26, in part due to lower interest rates early in the year. In 2026-26 growth is zero and 2.0 per cent for the following fiscal year. For the 2026-2027 period the Australian unemployment rate is 5.5 per cent and then drifting up to the 6.0 per cent mark due to the relatively poor prospects for the world economy.

The second part of the chapter explores the resilience of the United States political-economy in order to assess the probability of the base case, as well as the nature of potential alternative scenarios. The findings are that the resilience of the United States is very poor.

The United States is de facto a plutocracy. Legislation passed over the decades is mainly in the interests of the high-income earners and major corporations. The interests of the very top income earners, the plutocrats, is to maximise their disposable income in part by reducing or eliminating direct taxes and, if taxes have to be increased, then do it via indirect taxes and preferable by fixed nominal indirect taxes. In this they have been very successful. In 1990 the average member of the top 1 per cent received 43 times the average pre-tax income of the bottom 50 per cent of income earners. By 2022 this had grown to 100 times the bottom 50 per cent of income earners so that by 2022 the top 1 per cent in total received twice the total income of the bottom 50 per cent. The United States Federal income is, on average, only mildly progressive. However, at the very top the tax system is regressive. The 400 wealthiest families pay an average direct tax of 8 per cent compared to an average 13 per cent across all incomes. This is what one would expect in a plutocracy.

Moreover, the plutocrats have been using their steadily increasing wealth to enhance their control over the political process by funding the election cycle. For the 2024 election 18 per cent of direct funding will come from billionaires, which is considerably increased once account is taken of their control/influence over corporations and allied advocacy/research institutions. Over 25 per cent of the Trump campaign costs are funded by four billionaires.

The design of the United States health system is, firstly, to minimise direct tax support via its funding via employment and, secondly, as a wealth pump for the top income earners. The cost on employment is uniform starting at US$6,000 and extending into the $ teens, depending on coverage, so that it has destroyed low paid full-time employment, or so-called entry level jobs, and turned reasonably paying full-time employment into low quality employment, both in terms of renumeration and hours of work. That is, it has created millions of jobs of despair leading to deaths of despair killing millions well before their time, also because of its high cost and patchy service coverage compared to comparable jurisdictions, especially those in the bottom 50 per cent of income earners. The United States has a life expectancy that is up to seven years less than its peers, despite the United States spending over 17 per cent of GDP on health care compared to around 11 per cent for its peers. The difference or US$1.6 trillion is excess costs created by the approach that unconstrained free market mechanism is optimal for determining prices in the health care industry. This represent an average cost impost of over US$12,000 on all households, a large part of which is transferred to the high-income households.

The State fiscal system is in a race to the bottom with states abolishing direct taxes to attract the wealthy, skilled and industry, thereby undermining the economies of immediate past successful regions.

The local funding of the education system will ensure that the future generations from the families of current high-income earners will face limited competition.

Given all this, the probability that the base case will see a successful deficit control outcome in a relatively short period of time must be rated significantly less than 50 per cent. The probability of a period of rolling crisis with successive partial measures leading to crisis then recovery then crisis must be rated relatively high with poor world growth prospects for the 2030s. There are also darker scenarios that would involve China.

China, when measured properly, has a GDP that is a quarter again bigger than the United States. Given its substantial productivity gap with the United States, it has the capacity to grow three to four times greater than the United States provided that it maintains a high savings rate to equip the average Chinese worker with the same capital equipment and knowledge stock per capita as their American counterpart. China is doing this so successfully that on the technology front it will become the productivity benchmark, not the United States, for many industries by the 2030s. China's high technology sector is currently growing at approximately three times the GDP growth, which has more than offset the damage done from the collapse of the housing-property sector over the past six years. Under the base case, by the mid-2030s China will be bigger than the United States and Europe combined.

China is using this economic strength in relation to defence expenditure so that currently it's greater than the United States and growing up to 7.2 per cent per annum greater than the United States. Recent United States reports implicitly acknowledge this and in an increasing number of areas China has the advantage. The situation is now where China can duplicate the President Reagan strategy of crushing the Soviet economy by a rapid increase in defence expenditure. The Soviet Union tried to compete but the weak economic base and a budget deficit of 10 per cent of GDP in 1990 forced the collapse of its defence umbrella over Eastern Europe, which in turn led to the collapse of the Soviet Union. China could easily follow the same strategy by announcing a medium-term double digit per cent growth in defence expenditure, probably during the bond market crisis. China's high savings ratio means that its capacity to lift defence expenditures is very high. If the United States plutocrats refuse to compete, that is, unwilling to pay the taxes this would entail, then there will be a collapse in the United States security umbrella over North Asia in the first instance with China taking back Taiwan without a fight similar to the re-absorption of East Germany into Germany in the early 1990s.

Those countries which lose the American security umbrella, potentially including Australia, would immediately be recognised as, at best, a de facto Chinese protectorate. There would immediately be a large net outflow of capital from both residents and foreign corporations and domestic investment rates would fall to low levels, in part because of the uncertainty of future prospects. Growth would only resume once long-term security was somehow re-established. These countries would face depression defined as a five-year period with at best zero growth.

The darkest scenario would be one where the loss of American prestige from the China victory and the inability to solve the deficit problem leads to the destruction of the current regime and its replacement with a de jure plutocracy. Elements of the Republican Party seem to be planning for this.

All that can be said at this stage is that Australia, from early 2025, will face its most challenging time since 1942.

1. The United States political-economy and Australia to 2040

1.1 Introduction

Each year NIEIR uses state and regional models to develop projections for a wide range of demand and industry quarterly variables for short, medium and long projection term horizons. The long-term horizon extends to June quarter 2040. In applying these models, a large number of exogenous variables, that is, variables not determined by the models, can be quantified and inserted into the models. The main component of the exogenous variables are international variables, such as individual country GDP, imports, inflation rates and interest rates. These variables, in turn, fully or partially determine Australia's exports by industry, the cost of imports, relative exchange rates, domestic inflation rates and domestic interest rates, etc.

This chapter focuses on the most important country in terms of its ability to influence world economic stability via its influence on world financial flows. The United States is no longer the most important country in terms of its direct impact on world economic growth. It has been displaced by China since 2016. Its importance now lies in its ability to destabilise world financial flows, and hence, the world economy if there is a severe shock/meltdown in its financial markets. This was clearly seen in 2008-2009 when a meltdown in United States housing markets led to a high instability in financial markets generally and then to a Global Financial Crisis (GFC) and world recession. It is the conclusion of this chapter that the world is on the brink of a 2nd GFC arising from United States bond markets as a result of the United States inability to control its Federal public sector deficit. However, what could make the 2nd GFC far more serious than the 1st GFC is the degrading of many aspects of its political-economy, including the quality of its governance. In turn, it is this degrading process that explains the United States inability to control its deficit and, therefore, its ability to fix its deficit problem, which in turn may well extend a 2nd GFC to a much larger time frame than the 1st GFC. At worst the resilience of the United States political-economy may have been degraded to the extent that the response to a bond market meltdown may lead to depression in parts of the world economy defined as; at best, five years of zero growth.

It is useful to first review NIEIR's 2023 view and aspects of the short-term 2024 projected outcome for Australia. This is because the United States and Australia are not in dissimilar situations in relation to the inflation issue.

1.1.1 Background: The current projection and the 2023 projection

There are substantial differences for the timing of the economic growth profile for the projections of this report and the immediate past report issued at the same time last year.

The key outcomes in the previous projections were:

- two years of low economic growth, around 1.0 per cent for both 2023-24 and 2024-25;
- the unemployment rate climbing to near 6 per cent;
- core and headline inflation stabilising around 2.5 per cent by mid-2025; and
- interest rates declining from early 2025.

The rise in the unemployment rate in 2024-25 was central to the analysis. Its importance was due to its role as a driver of productivity growth in the post COVID-19 environment. In the last report there was a lengthy analysis of the reasons for the productivity decline during and since COVID-19. The key point, however, was that one of the significant reasons for the loss of productivity was labour hoarding arising from the fact that with the unemployment rate being at historically low levels, employers would be encouraged to maintain more labour as a safeguard to having available supply in the event of employee loss from attrition rates. Attrition rates are also likely to rise when the aggregate unemployment rate is low.

The outcome for the first year of the projection, that is 2023-24, was in line with this expectation. This will not be the case for the second year of the projection, namely 2024-25.

1.1.2 State and Federal Budgets – May-June 2024

The State and Federal Budgets of May-June 2024 significantly changed the outlook for 2024-25 and beyond. The reason for this is that the combined impact of the budgets was significantly expansionary in terms of its impact on aggregate demand. In approximate terms, along with the long-known stage three tax cuts, the additional budget measures will have a combined impact of between 3 and 4 per cent on demand.

A central phase of the measures was temporary energy price reductions, which for 2024-25 will reduce the CPI inflation rate by approximately 2 per cent. Conversely, when the measures are removed for 2025-26, 2 percentage points will be added to the headline inflation rate.

More importantly, the unemployment rate will remain at a little above 4 per cent for 2024-25 and economic growth will approach 3 per cent per annum. Under these conditions, core inflation is likely to be at least on the high side of the target range so that the headline inflation rate is likely to be at least 4 per cent over the second half of 2025. That is, the economy is likely to be well away from the conditions for a declaration of victory over inflation to be valid. More importantly, there would be a greater than 50 per cent probability that an exogenous price shock arising from war in Ukraine, war on the Israel frontier, other locations such as the South China Sea, or as climate induced agriculture supply shocks either restricted to Australia or another location with agriculture product supply that is significant compared to total world production.

This represents an application of the so-called Murphy's Law which found relevance in the inflationary period 1972-1983. Murphy's Law states that what can go wrong, will. Governments over the period constantly introduced policies to bring inflation under control by what is now called soft landing targets, leaving little margin for things going wrong. They always did. The problem was only solved when policies were adopted to allow interest rates to take whatever level that was required to break inflation and inflation expectations as quickly as possible.

At the centre of this assessment is a list of conditions adopted in these reports that must apply before a victory over inflation can be declared.

To be more specific. Victory over inflation cannot be declared until the following conditions are met and sustained for at least a 12-month period:

(i) the unemployment rate is in excess of 5 per cent;

(ii) real wages growth equals long-run productivity growth; and

(iii) core inflation growth is not more than 2.5 per cent per annum.

If these conditions prevail it means that temporary shocks to inflation which take the headline inflation towards 3 per cent will only be a temporary phenomenon. The United States and Australia do not currently meet these conditions.

The conclusion at the heart of this report is that on the balance of probabilities over the second half of 2025-26, the Reserve Bank of Australia (RBA) will not be in a position to significantly reduce interest rates from current levels and if the RBA does start reducing rates over the first half of 2025, it will probably have to reverse by increasing rates over the second half of 2025. Rates will have to be held at high levels until the unemployment rate settles between 5 and 6 per cent. That is current policy settings assume that little can go wrong if the policy objectives are to be achieved. In these circumstances, there is a high probability that Murphy's Law will prevail.

From Table 1.2 for the 2024 year, the world economy is projected to grow by 2.8 per cent, representing a decline from the 2023 growth rate of 3.2 per cent. A significant reason for the decline is the decline in the United States GDP growth rate from 2.5 to 1.8 per cent in 2024, under the impact of a tight monetary policy regime.

Like Australia, the United States is well away from the conditions that would justify a declaration of victory over inflation. The United States unemployment rate has risen only slowly from its 3.8 per cent level for 2023. As of August 2024, the unemployment rate is 4.2 per cent. This compares to a long-run average unemployment rate for the United States of 5.7 per cent.

1.1.3 United States inflation

As of August 2024, the core inflation rate in the United States is 3.2 per cent. This represents an improvement from the 3.9 per cent rate at the beginning of 2024. However, it is a considerable distance from the 2.5 per cent benchmark, especially when the time should be allowed for to assess the stability of the current outcomes.

Nevertheless, in September 2024 the United States commenced reducing the United States interest rates by 0.5 percentage points. The markets expect and the Central Bank has indicated substantial further reductions, around 1.5 percentage points, over the next 12 months. If this proves to be the case, then a probable United States economic profile would resemble Australia's with the United States monetary authorities being forced to reverse track and raise interest rates by the end of 2025, or at the latest the first half of 2026.

However, it is likely that these headwinds would only be one of several catalysts for a United States bond market crisis ushering in a 2nd Global Financial Crisis (GFC). This is because higher interest rates for longer would contribute to taking the public sector deficit, actual or merely expected, to levels that bond market investors will be unable to accept, thereby triggering a 2nd GFC.

Once triggered the 2nd GFC will take over as the main driver of Australian economic outcomes.

Section 2 outlines the world economy base case and the reasons for the inclusion of a 2nd GFC. The implications for Australian aggregate growth are also shown. Section 3 considers the strength of the Chinese economy and concludes that it is indeed strong. Section 4 considers the resilience of the United States and concludes that it is poor. It is defacto a plutocracy with the core design element in most public policy being the maximisation of the disposable income of the top income earners, that is minimisation of their direct tax and the immiseration of the bottom 50 per cent of income earners. The health care regime is a perfect example of this along with education policy. As a result, the United States, despite spending 17.3 per cent of GDP on health is killing millions, indeed most, of its citizens early compared to comparable jurisdictions and, in particular, the low-income earners. This appears a valid explanation of the current situation of why a large segment of the electorate appears willing to elect a government party where elements seem to want to destroy the current institutional governance structure of the country.

This leads, in Section 5, to a probability assessment of the base case, relatively low, and the alternative, more pessimistic scenarios which may eventuate if the financial crisis triggers a meltdown not just in bond markets but across many dimensions of the United States political-economy.

1.2 The world economy to 2040: Base case

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It is likely, however, that these headwinds would be a catalyst for a United States bond market crisis, ushering in a 2nd Global Financial Crisis (GFC). However, a United States bond market crisis will also stand on its own for triggering a GFC.

1.2.1 The United States Federal public sector deficit

In its latest report the Congressional Budget Office (CBO) estimated that the United States Federal public sector deficit (herein after referred to as the deficit), is at 7 per cent of GDP for 2024, or US$1.9 trillion, and the outcome for 2034 would also be a projected deficit of 7 per cent of GDP. In a similar report in early 2024, the CBO estimated that the deficit by 2034 would be 1 percentage point of GDP less at 6 percentage points.

Part of the increase was changes in the economic outlook and the accumulated impact of higher deficits in interest costs. However, part is due to legislated changes during the year, including:

(i) enhanced tax credits for the purchase of health insurance;

(ii) enhanced earned income and child tax credits; and

(iii) significant increases in expenditure on nutritional programs, social security and education.

1.2.2 Why the estimates for the 2034 United States public sector deficit will be continuously revised

There will be constant future upward revision to the United States deficit as per the revisions in 2024 as against the estimates prepared at end of 2023. This is mainly due to the CBO assumptions made in preparing the estimates are not credible.

The assumptions made at the end of 2023 will be the focus here.

Firstly, the CBO assumes the GDP growth rate over 2023-2034 will average 2 per cent annually. The Conference Board, a credible forecasting body whose work is often used in the preparation of these reports, estimate the average United States growth rate over this period at 1.6 per cent. The loss of Federal Government revenue from this growth gap will be approximately US$0.45 trillion by 2034, or 1.2 per cent of 2034 nominal GDP.

The second element of concern in the text of projections is the 2017 Trump Administration tax reductions. These were due to expire in 2025 which the CBO assumes for the case. For the current election campaign both parties are promising to maintain at least some of the 2017 tax reductions. If they continue in the existing form, they would add to the deficit on average US$0.4 trillion a year between 2025 and 2034, or 1 percentage point of GDP.

As at beginning of October 2024 the assessed campaign promises from the two parties, from Table 1.1, range between an average annual deficit increase (compared to baseline) from 1.1 per cent to 4.9 per cent. In the context of a divided Congress, a negotiated settlement of an increase in the deficit of approximately 1.5 per cent of GDP would appear to be realistic. This would include the extension of at least a significant part of the 2017 tax reductions.

Table 1.1 Harris versus Trump: Annual average 10-year increase in deficit (per cent of GDP)

	Harris	Trump
High	2.6	4.9
Central	1.1	2.4

Source: Committee for a Responsible Federal Budget. https://www.crfb.org/papers/fiscal-impact-harris-and-trump-campaign-plans.

Thirdly, there is the issue of the interest rate assumption. The CBO assumed that the effective federal funds borrowing rate falls from 5.1 per cent in 2023 to 2.9 per cent by 2027 and stays at that level until 2034. Even if the inflation rate comes back towards 2.5 per cent the historical record indicates that the setting would be implausibly low. The long-term average for the effective funds rate is 4.6 per cent. Taking the difference between the long-term average and the average assumed by the CBO, the additional interest cost by 2034 would be US$0.6 trillion, or 1.6 per cent of GDP. This upward revision would take place at least over the balance of the 2020s if, as expected, too fast a reduction in interest rates over 2024-25 leads to a reversal of policy over the second half of 2025 and sharp upward short-term projections of the deficit.

Finally, the CBO assumes that discretionary Federal Government expenditure falls from 6.4 per cent in 2023 to 5.1 per cent of GDP by 2034. This outcome is almost the same as assuming discretionary expenditures will be held constant in real terms from 2023 to 2034 despite population growth and other demands on Government, such as resources to facilitate the transition to a low emissions economy. This is not credible.

For defence expenditures, the assumption is that in real terms the expenditures will increase from US$0.80 trillion to US$0.83 trillion by 2034. This is not credible. As is noted below United States defence expenditure is currently less than China's, which in turn is growing at 7.2 per cent per annum. A recent Congressional Commission, also noted below, called for United States defence expenditure to increase by up to 5 per cent per annum. This would add 0.5 per cent to the deficit, as a per cent of GDP, by 2030 and a full 1 percentage point by 2034.

If a similar adjustment is made to the other component of discretionary expenditures, then around the deficit will increase by 1.4 per cent of GDP by 2034.

In any case, by replacing the CBO's implausible assumptions with credible ones, will add at least 5.7 percentage points of GDP to the deficit by 2034. Given the 7 per cent baseline, this implies a deficit greater than 12 per cent of GDP. A large part of the changes will impact on the deficit as much in 2027 as 2034. It is therefore likely that with unexpected changes, as per 2024, expected deficits in excess of 10 per cent of GDP will be projected over the last few years of the 2020s. Indeed, the total debt outstanding to GDP ratio would be increasing by between 5 and 6 percentage points of GDP. The inevitable consequence of this arithmetic is a risk-off shock, its technical name, in United States bond markets or its more popular name of a bond market crisis or meltdown.

The risk-off shock will be similar in structure to the risk-off shock in United Kingdom bond markets in September 2022, when the Government of the day announced tax cuts that were not sustainable in terms of the United Kingdom deficit projections. Interest rates remained elevated at high levels, risking some financial institution collapse, until the policy was cancelled and the ministers behind the policy removed.

It will be the same for the United States, although political leadership cannot be removed as quickly as in the Westminster system. Interest rates will remain at high levels until the President and two Congressional leaders agree to enact a plausible deficit reduction strategy. For life to go on after the event, as the West has known for 77 years, the plan will require that the bulk of the deficit reduction burden will have to fall on the top 10 per cent of income earners in general, and the top 1 per cent in particular.

If the United States takes the 'easy way out' politically, by cutting discretionary expenditures in general and defence expenditures in particular, then it would be akin to the late 1980s when the Soviet Union conceded that it had lost the economic race and decided that it could no longer afford its defence infrastructure and spheres of influence. This led to a rapid reorganisation of spheres of influence. As noted below the response to that usher in a world depression as is more fully explored below.

Even if the United States does not reduce defence expenditures it will not have the capacity to grow them. If the Western alliances are to be kept in place this will only occur if all participants lift defence expenditures to 3 to 4 per cent of GDP. Substantial uplifts in defence expenditure over the 2030s have been assumed in these reports for some time. This is partly factored into the current projections with the increase in Australian defence expenditures and lower world growth,

1.2.3 How would a 2nd GFC commence?

Quoting Katie Martin, *How Liz Truss still haunts markets,* Financial Times, June 1 2024.

> *"In the US, the Congressional Budget Office has sounded the alarm. Back in March, CBO director Phillip Swagel said that the US fiscal burden was on an 'unprecedented' trajectory, name-checking Truss as an example of the 'danger' inherent in sparking abrupt market reactions. So it was again this week, when a shaky auction of US government debt shoved bond prices lower, and therefore yields higher, unnerving holders of other asset classes in the process. Wednesday's eye-catching debt auction was not a disaster, but it was not the usual smooth process either. Underwhelming demand for the $44bn in new seven-year notes meant that so-called primary dealers — the big banks that make Treasuries trading tick, stepping in to make up any shortfalls — bought 17 per cent of the debt, somewhat above the norm."*

In short it could start when an auction fails and the institutions which normally make up shortfalls refuse to do so. This will be when a significant proportion of the market forms the expectation that interest rates will continue to rise until the deficit issue is resolved. If immediate liquidity is a constraint the continuing to buy Government bonds would guarantee immediate capital loss and technical bankruptcy in mark to market bond portfolio valuations. Of course, the 2nd GFC could simply start on a normal day's trading in existing issued bonds. In the space of a few minutes bond prices would fall raising interest rates by up to 2 percentage points. This would simply be the result of a number of market participants deciding that what has been going on cannot continue. Over the next few days, the carnage would intensify once it is realised that Central Bank support for the purchase of bonds cannot form part of the solution. That is, it is part of the problem.

The background to the bond market meltdown will probably be when the new administration tries to put its fiscal program through Congress. Also, the Chinese could facilitate the meltdown by deciding to sell a large amount of their bond holdings in a concerted effort to crush the United States economy.

1.2.4 How would the reconciliation process be conducted?

United States has experienced a similar event before. In 1990 a recession was threatening from high interest rates. The Central Bank governor, Alan Greenspan, reflecting market sentiment, refused to reduce interest rates because the deficit was too high. At the time the deficit reached in excess of 4 per cent of GDP. The policy impasse was only ended when the president of the day and the four Congressional leaders struck a bipartisan agreement over a weekend at Camp David to bring the deficit under control by adopting the PAYGO system where any new expenditure initiative had to be funded by new offsetting revenue raising offsets. This was more or less maintained by the two succeeding Democratic presidents, namely Clinton and Obama, but unfortunately not by the two succeeding Republican Presidents.

This time around the group will have to be a 'standing' group as resolution will not be achieved over a weekend.

One thing is certain. To achieve the degree of reform required, the pressure on the political-economy would have to be very, very intense. This would arise naturally from a bond market meltdown. The longer interest rates remained elevated the greater the risk of wide-scale private financial institution collapse as well as collapse of highly geared non-financial sector companies. Initially the flight of non-insured deposit holders in banks which had unacceptably mark to market capital losses on their government security holdings would lead to the collapse of the banks impacted. Over the medium-term United States banks are particularly unstable in disruptive markets because their mortgages are largely fixed in 30-year loans limiting their ability to lift deposit rates and therefore hold deposits. The pressure on politicians to reach an agreement and thereby avert another Great Depression would be immense. However, this might take up to six months to a year to achieve because of the political power of the interests that will be adversely impacted by the policy solution. To avoid a double-digit decline in GDP the program will have to be credible and phased in over time. The markets probably won't accept longer than five years.

China would be expected to push the crisis along by selling United States government bonds at times when the market turmoil is at its greatest. It would be constrained to some extent by the fact that this would risk United States cancellation of its debt holdings. However, maybe China would not care as this would further destabilise the world financial system to change the world financial system to its advantage, such as to weaken the standing of the United States dollar as will inevitably happen from a 2nd GFC.

1.2.5 The current dire state of United States public finance

The dire state of United States public finance is not simply due to the size of the deficit and the trends in the size and the implications for total debt. Of more importance is the limited scope policy authorities have of correcting the deficit. It also comes from the political power that will be applied to protect privileged positions. Total and Federal income tax as a per cent of GDP is 8.6 per cent. Add in corporate taxes and the ratio then becomes a little over 10 per cent of GDP. When the crisis is realised, assumed in this report to be late 2025/early 2026, the short-term projections are likely for a deficit of in excess of 10 per cent of GDP. Markets are unlikely to restore interest rates to normal levels unless there is a credible program to reduce the deficit by 7 percentage points of GDP within at most five-year time frame. To do it at once risks up to a double digit fall in GDP To do this via direct taxes only would require a 70 per cent increase in current direct tax rates with the top 1 per cent of income earners having to pay a disproportional share. This would be appropriate given the long-run cause of the crisis has been the income tax cuts that have largely benefitted the top 10 per cent of income earners since President Reagan.

In this context the core objective of many of the top 1 per cent in the United States to minimise their tax payment seemingly has no bounds. The current Republican policy proposal, knowing full well the deficit cannot be used again to fund tax reductions, is to obtain the extra revenue from increasing tariffs. This imposes a very regressive tax on the bottom 50 per cent of households by income, severely aggravating an already poor standards of income redistribution. This is to be expected. The substantial financing of the United States health sector via the commercial sector has the same impact and has become a wealth pump for the top 10 per cent of households. This explains why the United States spends 17.3 per cent of GDP, more than 50 per cent of many of its peer high-income countries, on health care and has a life expectancy of 77 years compared to 82-84 years life expectancy for its peers.

Given the current political power of the top 1 per cent, via their funding of political activity, the economic agreement to end the crisis will require very large economic pressure which will come from the sharp and unexpected rise in interest rates, triggering bank runs, collapse of financial institutions and over-leveraged companies. This will be on a much larger scale than the previous bond crisis triggered by the United Kingdom Prime Minister's, Liz Truss, attempt to impose unfunded tax cuts. They are not going to take too kindly to proposals to increase their tax rates multiple times.

So-called discretionary Federal expenditure amounts to 6.4 per cent of GDP where defence expenditures comprise a little under 50 per cent of the total. The rest is largely made up of government administration expenditures. Defence expenditures currently comprise 3 per cent of GDP. Italy, in 2022, have a public sector deficit of 7 per cent of GDP and will, in the near term, reduce it to the required EU level of 4 per cent of GDP. France currently has a deficit of 7 per cent of GDP. However, the total task is considerably easier in economies such as Italy and France, where the combined tax revenue/government expenditure is in excess of 80 per cent of GDP. In these cases, relatively small changes in revenues and expenditures are required to achieve deficit control objectives and with substantially more scope to phase in adjustments over time.

This is why a bond market crisis will occur earlier rather than later in the United States despite the United States having a debt to GDP ratio significantly less than Japan. A deficit at 10 per cent of GDP would require an 8 to 15 per cent decline in GDP to correct in the short-term from expenditure reductions and tax increases which is why a 5- to 10-year phase in period is needed. Further increases in the deficit would increasingly render the problem intractable and force short-term adjustment, no matter what the cost, as was the case with Greece.

1.2.6 The world GDP profile

The 2nd GFC is assumed to commence at the end of 2025. The 2nd GFC will be more complicated than the last GFC. For the 1st GFC the solution was the restoration of liquidity and sustainable balance sheets by using the balance sheets of the Central Banks, the central government and strong private sector institutions. For the 2nd GFC it's the quality of central government balance sheets that is the problem.

Nevertheless, it is possible to see parallels between the severe recessions of the early 1980s and subsequent recovery and the current circumstances. A decade from 1973 of trying various alternative policy combinations aimed at minimising the impact on the unemployment rate, including the direct control of wages rates via prices and income accords, as well as Monetarism or trying to influence inflationary expectations by control of the money supply growth, ended in failure. Decisions were taken to sharply increase interest rates and drive the unemployment rate to whatever the level required to kill any expectations of ongoing inflation.

Once inflation and inflationary expectations were reduced to desired levels, recovery was driven by the recovery in real income from falling inflation rates relative to the growth in nominal incomes, and increasing real incomes from falling nominal interest rates. These mechanisms will also come into operation once policies have been agreed upon to solve the United States deficit problem. Finally, if the bulk of the policy adjustment falls on the real income of the top 1 per cent there is likely to be minimal impact on real household consumption expenditure because their saving ratios are very high. That is, these households have ample scope to cushion the impact of higher taxes on consumption expenditure by reducing their savings ratios.

From Table 1.2, 2026 is the worst year of the bond market crisis. United States GDP falls by 1.2 per cent. The Euro Area GDP falls by just under 1 per cent, while Latin America GDP falls by 1.2 per cent. Japan and other world GDP fall by 1 and 0.5 per cent respectively.

Compared to the 1st GFC, the United States GDP fell by 2.5 per cent in 2009 and the Euro Area fell by 4.6 per cent. Japan GDP fell by 5.7 per cent and Latin America GDP fell by 2.4 per cent. The impact of the 2nd GFC is assumed to be less than the 1st GFC in the first year. However, in the second year of the 2nd GFC stagnation applies to the United States, Japan, the Euro Area and Latin America, partly because expansionary fiscal policies will be constrained by the need to repair government balance sheets. For the 1st GFC world GDP grew by over 5 per cent in 2010. For 2027 world GDP growth is projected at a very modest 1.6 per cent and the United States is stagnant.

Any profile for the severity of the 2nd GFC has to be speculative. It will depend on the scale of economic damage required to force a United States bipartisan agreement. All that can be said given the scale of political power wielded by those who will have to pay most of the cost, if the Western World is to avoid a depression, then a realised GFC not too far into the future has to be a near certainty. As the current election campaign in the United States has demonstrated, normal politics is incapable of forcing a solution.

1.2.7 Post the 2nd GFC

The 2nd GFC will leave scares that will reduce medium-term growth as did the 1st GFC. Part of this will come from loss of confidence in the future and, therefore, willingness to invest. This will manifest itself in an increase in the required minimum rate of return on investments. This will certainly apply to the United States.

The world will split into two trading blocks, one centred on Europe, the United States, Japan and Korea while the other will centre on China. It can be seen from Table 1.2 that by the mid-2030s China's GDP will be the same size as that of the United States and Europe combined. However, since China's savings ratio is twice that of the United States and Europe is relative power at the margin, such as being able to support desirable digit growth in defence expenditures. To accomplish this, there is going to have to be a high degree of coordination between Western allies if the alliance is to be effective and confidence in the future maintained at a level to maintain, albeit modest, growth rates.

Rapid growth in defence expenditures will also reduce growth by diverting expenditures from investment to consumption.

World growth over the second half of the 2020s averages 1.8 per cent and 2.4 per cent over the 2030s. This will represent a considerable reduction from the 3.5 per cent world growth from the turn of the millennium to the onset of COVID-19.

Of course, the timing of the 2nd GFC FC is critical in determining the profile. It is plausible that the timing of the 2nd GFC could be postponed to 2028. However, given the dysfunctionality that seems certain to result from the 2024 presidential election, no matter who wins, it seems almost certain that the 2nd GFC will not be postponed for too long. If a Trump administration introduce tariffs, they are assumed to be abandoned during the crisis for reasons to protect the status of the dollar.

The resulting model based medium-term projections for the Australian demand components of GDP are given in Table 1.3.

Figure 1.1: World GDP: Annual growth rate (%) – calendar years

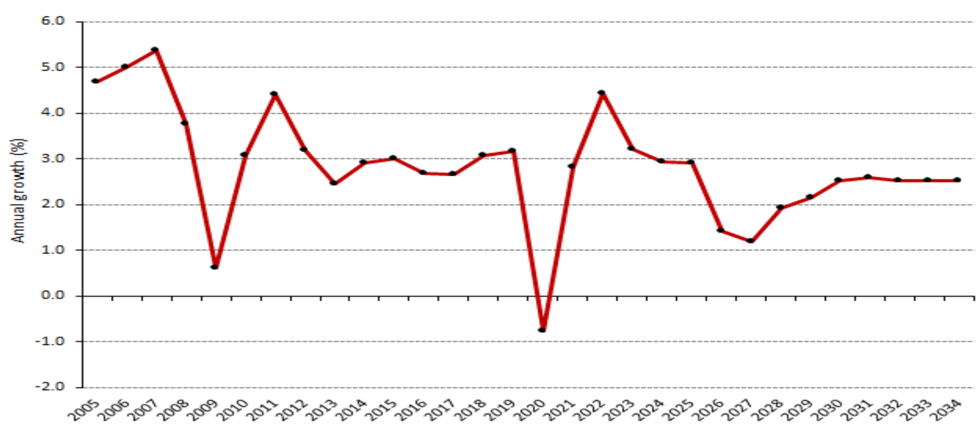


Table 1.2	**World economy: Average annual growth rates by major economy region (%)**														
	1990-2000	**2000-2010**	**2010-2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**	**2031-2040**
United States	3.4	1.8	2.4	-2.2	5.8	1.9	2.5	1.8	1.4	-1.2	0.2	3.1	3.2	1.8	1.5
China	10.5	10.6	7.3	2.2	8.4	3.0	5.2	4.7	4.4	3.5	3.9	4.0	4.1	4.1	3.7
Euro Area	2.1	1.2	1.3	-6.3	6.0	3.5	0.5	0.5	1.1	-1.0	-0.1	0.0	0.1	1.2	1.0
Japan	1.3	0.6	0.9	-4.1	2.6	1.0	1.9	-0.2	1.1	-1.1	0.0	0.1	0.1	1.0	0.8
South Asia	5.3	6.3	6.2	-4.6	8.8	6.4	6.5	5.2	5.0	3.8	3.9	4.0	4.1	3.9	3.5
Latin America	3.2	3.1	1.7	-6.5	7.1	4.0	2.1	1.2	2.5	-1.2	0.4	0.5	0.6	1.8	1.5
Other world – (Africa, Oceania, former Soviet Union)	1.7	4.1	3.1	-3.2	5.4	3.3	2.6	2.9	3.2	-0.5	1.1	1.1	1.2	2.6	2.1
Total world	**2.8**	**3.6**	**3.4**	**-2.9**	**6.4**	**3.3**	**3.2**	**2.8**	**3.0**	**0.5**	**1.6**	**2.1**	**2.2**	**2.7**	**2.4**
Share of world GDP (%)															
United States	19.3	18.3	15.7	15.2	15.2	15.0	14.9	14.7	14.5	14.3	14.1	14.2	14.3	14.2	13.5
China	5.1	9.2	15.2	18.2	18.5	18.5	18.8	19.2	19.4	20.0	20.5	20.8	21.2	21.5	23.1
Euro Area	19.7	17.1	13.4	12.1	12.1	12.1	11.8	11.5	11.3	11.2	11.0	10.7	10.5	10.4	9.6
Japan	7.1	5.5	4.2	3.7	3.6	3.5	3.5	3.4	3.3	3.3	3.2	3.1	3.1	3.0	2.8
South Asia	5.1	6.4	8.3	9.1	9.3	9.6	9.9	10.1	10.3	10.7	10.9	11.1	11.3	11.4	12.1
Latin America	8.7	8.1	7.6	6.7	6.8	6.8	6.8	6.6	6.6	6.5	6.4	6.3	6.2	6.2	5.9
Other world – (Africa, Oceania, former Soviet Union)	35.0	35.4	35.5	34.9	34.6	34.5	34.4	34.4	34.5	34.2	34.0	33.7	33.3	33.3	32.9
Total world	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

1.2.8 The formation of Australian GDP

Over 2023-24 private household consumption expenditures grew by 1 per cent per annum. The fall in headline inflation is likely to lead to a 2.3 per cent growth in real household consumption in 2024-25 and a similar growth in 2025-26 as the lagged impact from the energy price subsidies and the stage three tax cuts offset the initial impact of the subsidy withdrawal. For most of 2025 the expectation of continued interest rate reductions will induce households to reduce savings rates. For 2026-27, the combined impact of interest rate rises and the uplift in the unemployment rate will reduce consumption growth to 0.7 per cent. The growth rate will, no doubt, be supported by additional temporary measures to maintain demand in the economy. However, there will be limits to the extent this can be done because of contagion affects from the United States bond market meltdown. Markets will be assessing governments around the world for signs of unsustainable balance sheet settings.

The Victorian Government is likely to have a difficult time during this period.

This comment applies to current government expenditure and to construction expenditure. In 2026-27, current government expenditure is restricted to a 1.1 per cent growth whereas in previous downturns the growth rate could be as high as 4 to 5 per cent to stabilise the economy. In order to minimise the increase in interest rates, governments will have to calm markets with a degree of austerity. This applies to the government part of construction investment.

Dwelling investment will stage a brief recovery over 2025-26. The expectation of declines in interest rates will stimulate demand. However, this will prove short lived with dwelling investment being stagnant over 2026-27 and 2027-28.

Once the crisis is resolved relatively normal growth rates will be restored driven by the fall in interest rates and inflation. For the remainder of the projection period national household consumption expenditure growth lies within the range of 2.3 to 3.1 per cent. Over the remainder of the period current government expenditure averages close to 4 per cent. This in part will be due to the defence expenditure build-up. Dwelling expenditure grows rapidly over the 2028-29 and 2029-30 years. Over the 2030s equipment investment will also grow strongly, again due to the construction of defence platforms, such as the AUKUS submarines.

Given the commitment to expenditures in defence and climate change, the growth in per capita consumption expenditure will be determined by the growth in productivity. The less the productivity growth the greater will have to be the increase in tax rates to allow climate and defence expenditure commitments to be met. In this context realising the productivity losses from the COVID-19 period will be most useful.

A key direct driver for the translation of the 2nd GFC into the Australian economy will be the direct influence of United States interest rates on key Australian interest rates such as the fixed three-year bank mortgage rate. This is because of the importance to Australian banks of international financial markets for their wholesale funding requirements.

The national labour market

For 2024-25, the national GDP growth rate is estimated at 2 per cent, which is double the growth rate in last year's report, followed by a 2.3 per cent growth rate in 2025-26. For 2026-27, there is zero growth in GDP and total employment falls by 1.3 per cent. The unemployment rate reaches 5.5 per cent.

After years of low or falling labour productivity growth rates the 2024-25 to 2026-27 years mark two periods for increases in productivity growth rates. In 2023-24 labour productivity fell by 1.3 per cent. For the next two years, the labour productivity growth rate is projected at an average of 1.5 per cent per annum. The major year for the recovery in productivity growth is 2026-27. This reflects the central premise of last year's report that the recovery in productivity lost in the COVID-19 years and the post-COVID-19 years will only happen where there is a sharp increase in the unemployment rate. In 2026-27 national productivity rises by 1.3 per cent. Normally, when GDP growth is low, labour productivity is low or negative to cushion the impact on unemployment. This explains why there is such a significant decline in employment in 2026-27 with no change in GDP. Even so, after 2026-27 there is still additional scope for reclaiming past productivity loss. For 2026-27, national productivity is 3.4 per cent above 2018 levels. The trend labour productivity growth for 2006 to 2018 was 1 per cent. This implies that if productivity growth was at historical trend values over the 2018-2027 period, total labour productivity growth would have been 9.4 per cent over 2018-2027. Given the GDP profile this implies employment would have been 6 per cent lower than the projected level.

The importance of these potential productivity gains from the unrecouped losses of the COVID-19 period explains why national labour productivity growth averages 1.4 per cent over the 2028-2034 which is above the historical trends.

The average employment growth rate over 2028-2034 is 1.0 per cent. Given an average 2.5 per cent GDP growth over 2028 to 2034 and then the unemployment rate will average 5.8 per cent. This is, safely within the band for the unemployment rate to be consistent with stable inflation rates at the desired levels. The 2nd GFC allows the unemployment rate to be achieved in 2027 when the unemployment rate increases by 1.2 percentage points.

Table 1.3 **Formation of Australian Gross Domestic Product – Demand-side drivers**

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Annual growth – $CVM m (%)															
Private consumption expenditure	-3.3	0.9	4.3	5.9	1.0	2.3	2.4	0.7	1.9	2.6	3.1	2.5	2.2	2.6	2.3
Government expenditure	7.4	6.6	6.8	1.6	3.7	2.6	3.4	1.1	3.2	3.6	4.0	4.1	3.1	3.9	3.5
Dwelling investment	-6.7	8.4	-1.5	-2.3	-27.2	0.6	5.0	0.1	1.3	9.0	6.7	-3.3	-5.6	-1.9	-0.2
Construction investment	-3.4	0.9	2.8	3.9	3.2	1.7	3.7	0.0	0.1	1.5	-0.5	3.0	2.6	4.3	3.2
Equipment	-3.1	3.8	10.4	3.5	4.1	-2.0	5.0	1.0	-0.2	2.5	0.4	4.0	3.6	5.3	4.2
Total state final demand	-0.8	4.0	5.3	4.1	2.4	1.9	3.1	0.7	1.8	2.9	2.8	2.8	2.3	3.1	2.8
Net trade and stocks – percentage point contribution	1.7	-4.1	-5.1	-4.6	-1.4	-1.5	-3.4	-1.4	-1.4	-3.2	-2.5	-2.2	-2.1	-3.0	
Gross Domestic Product	-0.3	2.1	4.3	3.1	1.5	2.0	2.3	0.0	2.0	2.4	2.9	2.9	1.9	2.7	2.4
Percentage point contribution to Australian GDP growth															
Private consumption expenditure	-1.7	0.5	2.1	2.9	0.5	1.1	1.1	0.3	0.9	1.3	1.5	1.2	1.0	1.2	1.1
Government expenditure	1.4	1.4	1.5	0.4	0.8	0.6	0.8	0.3	0.7	0.8	0.9	0.9	0.7	0.9	0.8
Dwelling investment	-0.4	0.4	-0.1	-0.1	-1.3	0.0	0.2	0.0	0.1	0.5	0.3	-0.2	-0.2	-0.1	0.0
Construction investment	-0.4	0.1	0.3	0.5	0.4	0.1	0.3	0.0	0.0	0.1	0.0	0.2	0.2	0.3	0.2
Equipment	-0.2	0.2	0.7	0.2	0.3	-0.2	0.4	0.1	0.0	0.2	0.0	0.3	0.3	0.4	0.3
Total state final demand	-0.7	3.6	4.9	3.9	2.2	1.8	2.9	0.7	1.7	2.8	2.6	2.6	2.1	2.9	2.6
Net trade and stocks – percentage point contribution	1.7	-4.1	-5.1	-4.6	-1.4	-1.5	-3.4	-1.4	-1.4	-3.2	-2.5	-2.2	-2.1	-3.0	-2.6
Gross Domestic Product	-0.3	2.1	4.3	3.1	1.5	2.0	2.3	0.0	2.0	2.4	2.9	2.9	1.9	2.7	2.4

Figure 1.2: Australia – Key construction interest rate (%)

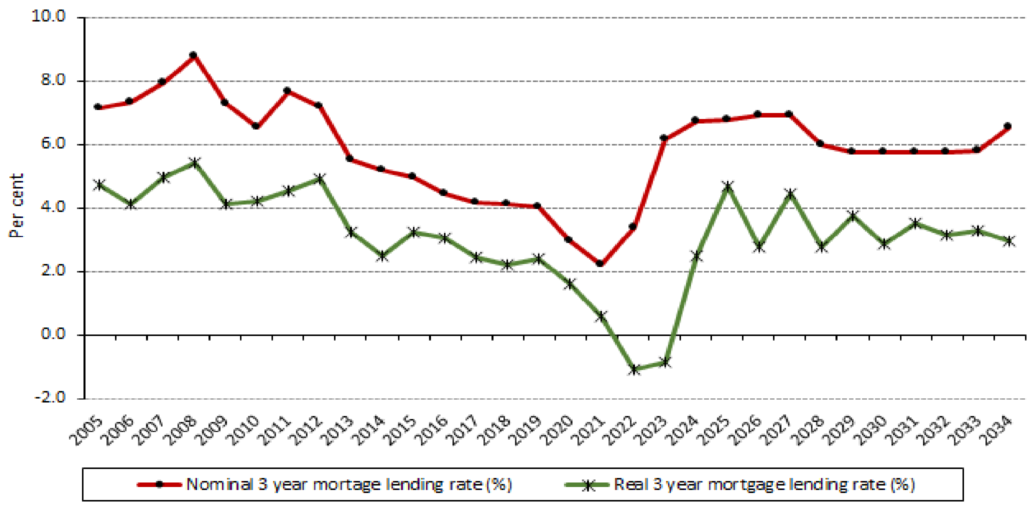
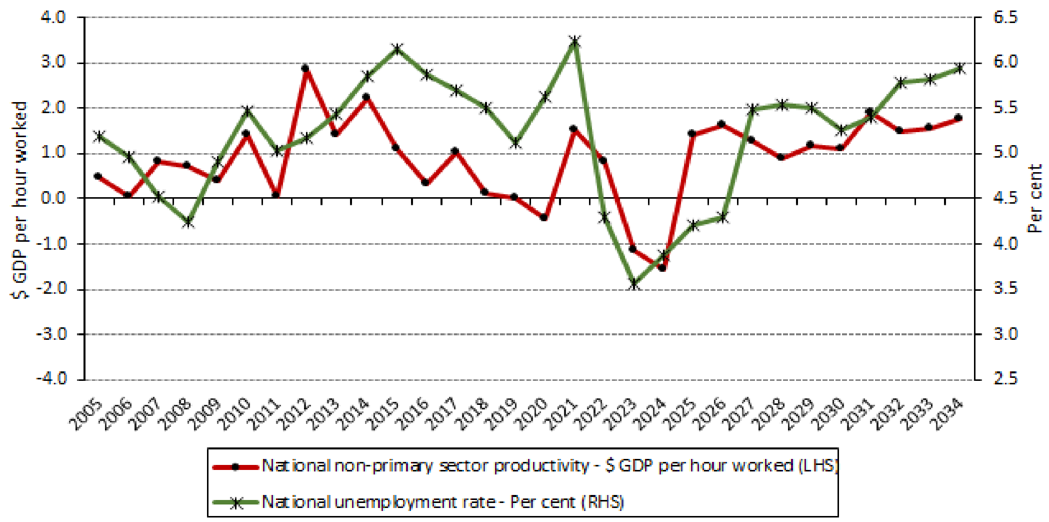


Figure 1.3: Productivity growth and the Unemployment rate (%)



1.3 The Chinese economy

Durning 2023 a mainstream Anglosphere media consensus seems to have emerged that the economic environment of China is dire and is a significant threat to the world and Australian economies. The points made in these articles generally include one or more of the following.

(i) Chinese economic power relative to the United States is in decline when measured in nominal $US and may now take many decades to pass the United States in GDP.

(ii) China has hit a demographic cliff. Like the Japanese, its workforce and population have started to decline, which is going to place severe capacity constraints on the ability to grow the economy. Following Japan, the expected growth rate would be between 1 and 2 per cent per annum.

(iii) The debt crisis created by the collapse of the Chinese housing price boom, like the 2009 property price crash in the United States, will lead to financial institution failure, substantial household negative equity in housing and a Chinese financial meltdown.

(iv) Sub national public sector debt is at extreme levels which will constrain economic activity for years.

The intensity of these claims has declined over 2024 but still resurfaces from time to time. There is no evidence to support these claims.

1.3.1 China is the largest economy in the world in 2023, with a GDP that is 26 per cent larger than the United States

The method to compare the size of economies is to derive what is called a 'purchasing power parity exchange rate' or 'PPP exchange' rate. The World Bank/IMF do this by carrying out cost surveys of individual economies across a wide range of products and services. They then compare countries by calculating the exchange rate which would have to prevail to make the product prices in both countries the same. The overall average of these calculations provides the PPP exchange rate. At the PPP exchange rate customers would be paying prices for a product or service that reflected the same standardised cost base of each economy. In these calculations the United States is the numeriere country and all other countries are benchmarked to the United States.

There is no requirement that the market exchange rate should bear any relationship to the PPP exchange rate, although for Australia, mining booms aside, the United States/Australian exchange rate has, on a trend basis, remained particularly close to the PPP exchange rate, which is approximately 69 cents.

In the Chinese case there is, and has been for decades, a wide gap between the PPP exchange rate and the market exchange rate, as a core policy objective has been to provide Chinese industry with maximum competitiveness.

In 2023 the Chinese PPP exchange rate is 3.9 RMB to the $US. However, the market exchange rate is currently approximately 7.1 to the $US. That is, the current Chinese market exchange rat provides Chinese industry with a cost competitive advantage of nearly 50 per cent compared to the United States economy and most other developed economies, since the market exchange rates are generally close to the PPP rates.

The central point is, however, that applying market exchange rates under-estimates the real value of the Chinese economy by almost 50 per cent. As at 2023, the World Bank, in constant PPP or international dollars, values the Chinese GDP at 26 per cent larger. That is, a valuation of $US PPP 24.7 for the United States and $US PPP 31.2 for China in constant benchmark year prices.

In United States dollar terms, the United States has already been displaced by China as the leading exporter. In 2022 total United States exports were US$3.0 trillion, while China's total exports were US$3.7 trillion, a 23 per cent margin in line with the GDP superiority. However, Chinese superiority in real items is significantly greater than this. This is because Chinese exporters will not price items in terms of United States dollar parities, but with reference to the PPP cost relativities, so as to be able to maintain maximum competitiveness and, therefore, gain maximum 'real' world trade market share. This means that the volume of Chinese international exports will be at least 50 to 70 per cent greater than what is suggested by $US trade values. That is, the Chinese share in volumes terms of world trade is at least twice that of the United States level. A goof platform to set up a trading block that will dominant the World economy in the coming decade.

A good example to illustrate this point is the case of motor vehicle exports. Chinese motor vehicle exports have increased from 0.4 million in 2015 to 1.6 million in 2021 to 2.7 million in 2022 4.9 million units in 2023, displacing Japan as the world's top motor vehicle exporter. In August 2024 Chinese motor vehicle exports were 39 per cent above the comparable level in 2023. Moreover, Chinese vehicles from locally owned producers are 40 per cent cheaper than Japanese and German competitors. Another important driver is Chinese competitive advantage in electric vehicles. China's motor vehicle exports are currently running at more than twice the United States level. The same multiple advantage to China to the United States can be found for many other products when examined in quantity terms, which is what one would expect when $US statistics are corrected with the PPP exchange rates.

1.3.2 China is not going to hit a demographic cliff

To hit a demographic cliff three conditions need to be in place, namely:

- the economy has reached full employment;
- the productivity of the economy, measured in terms of GDP per capita, approaches United States levels; and
- a slow growing or declining population.

If productivity is well below United States levels, even if full employment prevails, the economy can still continue to grow strongly if the economy continues to equip low productive workers with the average level of capital per worker and skills that prevails in the peer economy, that is, the United States. This of course means growing the new industries to absorb the newly equipped workers, which China has done successfully for 30 years. With the Chinese GDP per capita at 30 per cent of United States' levels, the Chinese growth potential is for an economy to grow up to three times the United States level before the demographic cliff would become binding. Japan hit a demographic cliff in the early 1990s because its productivity levels approached United States levels in the context of full employment and rapidly slowing population growth.

However, the fact that Chinese population has started to decline has forced a fundamental change in economic strategy. With the unemployment rate at its target level of 5 per cent and the working age population declining, the Chinese policy authorities had to end the housing construction-property development growth mechanism, which is labour intensive and adds little to high technology development. Since ending the housing-property development boom, the Chinese Government has been highly successful in driving resources into high technology industries. Between 2018 and 2023, high technology industries expanded 12 per cent per annum on average. These industries include medicine, advanced equipment, information technology, communications equipment and services and research and development. According to Bloomberg Economics, as a result these industries will account for 19 per cent of GDP in 2026 compared to 11 per cent in 2018, and the proportion of high-tech industries increases to 23 per cent if electric vehicles, batteries and solar panels are included. This growth has more than offset the decline in the property construction sector, which is expected to decline from 24 per cent of GDP to 16 per cent over the same period. This must represent one of the most successful restructures of a major economy in history other than in wartime.

The Chinese have, of course, been preparing for this over the last quarter century with successive 5-year plans have targeted the enhancement of the technological and skill base of the economy. The success of this strategy is quantified by the Australian Strategic Policy Institute's (ASPI) Critical Technology Tracker, which shows China is the country leading in 37 of 44 technologies that will drive future industry development. Leading in terms of research, personnel and output as measured by citations. To turn this advantage into industry development it needs to create the space capacity for resources to be allocated to allow this to happen. It is now doing that.

If China is to continue to grow at 4 to 5 per cent, the growth will have to be driven entirely by the increase in productivity. To follow Western Media advice to do more to stimulate the property-construction sector would lead to the worst possible outcome for the Chinese economy.

1.3.3 China is not going to experience a financial meltdown

A Chinese financial crisis is an oxymoron. This is because, in general, the Chinese Government/ Communist Party is on both sides of the balance sheet, aided by the fact that the country as a whole has the US$3 trillion in international reserves. The Government in the main owns the institutions which lends to the Government owned institutions that financed the construction/house price boom.

The current crisis could be dispensed with, with the stroke of a pen. That is by paper transfers of liquidity and/or debt forgiveness with zero overall impact. The Chinese central government does not want to do that because constraints on the spending power of sub-national governments is essential to create the opportunities for high technology industry development. The Central Government itself has very low debt and plenty of firepower to use its balance sheet to drive high technology industry development.

1.3.4 United States versus China: Defence capability

Since the ending of the Second World War the Western World has prospered because of the United States security umbrella. This has allowed countries, corporations and individual investors to invest with minimum sovereign risk from the security perspective which has made a significant contribution to overall growth. That may be about to end.

China's announced defence budget for 2024 was US$231 billion[1]. This compares with the CBO's latest estimate for 2024 of US$848 billion. These sorts of numbers have often led to the claim of very large United States defence superiority because it spends more on defence "*than the next 10 biggest countries combined.*"

The first adjustment to the expenditure would be to use PPP exchange rates instead of market exchange rates. This would double the estimate to US$462 billion, or 52 per cent of United States total. However, recent estimates by United States Government personnel have placed the estimate at around US$700 billion, or near parity with the United States. This is because of further PPP adjustment to obtain more accurate cost comparisons for specific defence equipment expenditure items.[2]

This is still likely to be an under-estimate. This is because China is a communist country without United States public sector accounting standards. Trillions in PPP US dollars of national savings flows through government owned entities such as corporations, and financial institutions when only a telephone call is required to divert more of national savings to defence that would by-pass the standard budgetary process.

> *"Many experts believe China's public defence budget does not include other military relevant expenses such as space activities, construction, and research. China's state-sanctioned practice of military-civil fusion further blurs the lines between military and commercial investments, resulting in*

[1] https://chinapower.csis.org/military-spending/.

[2] https://foreignpolicy.com/2023/09/19/china-defense-budget-military-weapons-purchasing-power/.

spending on combat power and paramilitary forces that is hidden within civilian ministries."[3]

Adjustment for under-reporting may well put Chinese expenditure considerably greater than the United States.

Surely one would think that the way for more clarity is to examine the statistics on actual military capacity.

The assessment of the United States bipartisan Center for Strategic and International Studies (CSIS) in 2024 was that the rapid build-up in Chinese naval capability:

> *".. the trends are pointing in the wrong direction for the United States. The U.S. Navy faces a growing possibility of defeat at sea for the first time in half a century, and the United States could soon face its first potential contender for maritime dominance since at least the collapse of the Soviet Union. China's naval might is already allowing Beijing to flex its muscles in the Pacific in ways that endanger U.S. allies and undermine stability. If the United States does not halt its relative decline, the world will face a more dangerous and uncertain future."*[4]

This conclusion is based on the following metrics.

(1) China now possesses the largest comparable (minimum tonnage) fighting force of 234 warships compared to 219 for the United States, many of which are on duty outside the Indo-Pacific.

(2) More importantly, China is expanding its navy at a much greater rate. Between 2015 and 2019 China built 90 warships compared to 30 for the United States, whereas between 2010-2014 the comparable figures were 58 for China and 18 for the United States. Currently China is outbuilding the United States 18 ships to 14 for the 2020-2024 period.

(3) Chinese shipbuilding capacity is unlimited compared to the United States as it currently has 230 times the shipbuilding capacity of the United States.

(4) Aggregate naval capacity is measured not only in number of ships but the total number of missile launch systems (or Vertical Launch Systems (VLS)) across all ships. In 2014 the United States had 10 times the number of VLS systems as China. In 2023 this ratio had been reduced to 2.3 and at the current rate of expansion China will reach parity by 2027.

The United States still has the advantage in nuclear submarines and aircraft carriers though the effectiveness of the latter west of Midway due to China's hypersonic missiles is questionable. The point is, however, that in naval capacity it is self-evident that China is spending considerably more than the United States. It is only now that the United States wilful blindness towards these basic facts is being removed.

In other areas China has currently deployed a range of nuclear hypersonic missiles which can fly 5-times the speed of sound. The United States, despite speeding US$12 billion, has yet to deploy one hypersonic missile.[5]

China is developing a wide range of space defence capabilities to the extent that current competencies would allow to "*easily deploy cyberattacks to degrade U.S. military operations in the early phase of a conflict by limiting mobilization and constraining surveillance and reconnaissance."*[6]

China plans to have a fleet of 1,000 j-20s by the early 2030s, while for the United States counterpart, the F-35, it is planned to have approximately 700 in the same time period.[7]

It is clear that the United States is rapidly losing its military superiority over China. This is also the conclusion of the Congress created Commission on National Defense Strategy. In a report issued in August 2024 the Commission concluded that:

> *"In reality, China is 'outpacing' America not only in the size but also in the 'capability' of its military forces, as well as in defence production, and the country is probably on track to meet its target of being able to invade Taiwan by 2027,"* argues the commission. *"In space and in the cyber realm, the People's Liberation Army is 'peer- or near-peer level'. ….. "The US public are largely unaware of the dangers the United States faces or the costs…required to adequately prepare,"* it says. *"They do not appreciate the strength of China and its partnerships or the ramifications to daily life if a conflict were to erupt. … They have not internalised the costs of the United States losing its position as a world superpower."*[8]

The Commission recommended that defence expenditure growth over the next five years be between 3 and 5 per cent per annum. This is still not competitive as China has set its target defence expenditure growth at 7.2 per cent per annum.

3 https://thehill.com/opinion/national-security/4624666-chinas-real-military-budget-has-quietly-become-almost-as-big-as-ours/.

4 https://www.csis.org/analysis/unpacking-chinas-naval-buildup.

5 https://www.bloomberg.com/news/newsletters/2024-03-12/bloomberg-evening-briefing-china-leads-the-world-in-hypersonic-technology.

6 https://spacenews.com/the-growing-chinese-space-threat/.

7 https://nationalinterest.org/blog/buzz/chinas-j-20-fighter-makes-us-air-force-generals-freak-out-210421.

8 https://www.economist.com/united-states/2024/07/29/america-is-not-ready-for-a-major-war-says-a-bipartisan-commission.

This report was largely ignored by the United States media. This is very surprising in an election year. A plausible explanation could be that the plutocrats who control the mainstream media do not want any policy issue which would weaken a low tax agenda to gain momentum. If so, this is treason, as is the case of the media relying for so long on the nominal dollar comparison of United States defence expenditure superiority to deflect any efforts to face up to the problem.

1.3.5 How much does China spend on defence?

From the above quantitative and qualitative analysis, an assumption that China spends the same as the United States on defence does not seem to be credible. A more realistic assumption would be that China spends a similar percentage of GDP as the United States. For the United States this is 3 per cent of GDP. This would produce a current expenditure estimate for China of US$1,050 billion. Even if China simply maintains the current 7.2 per cent growth rate, and in accordance with CBO assumptions the United States expenditure stays constant in real terms, by 2031 Chinese expenditures would be twice United States levels. To remain competitive United States allies would have to start moving to a defence expenditure target of 3 to 4 per cent of GDP from now on. It's likely, of course, that for China to win without fighting, as Reagan did in the 1980s against the Soviet Union, will in the next couple of years increase the annual growth rate to double digits and, no doubt, announce it in the middle of the projected bond market crisis.

1.4 The current status of the United States political-economy: Poor or resilient?

Before a probability can be assigned to the base case scenario, or the development of alternative scenarios can be undertaken, it is necessary to review the current status of the United States political-economy. Or more directly, its capacity to respond adequately to severe economic shocks.

1.4.1 The threat to the current United States institutional governance structure: The de jure plutocracy alternative

Prima facie the standard of governance has declined to the extent that there is now open talk of a non-democratic governance structure may be desirable to the existing one. Ever since the invasion of Congress on 6th January 2021, seemingly to prevent Congress certifying the election result of November 2020, the threats to United States governance practise from the Republican Party have drawn close attention. Robert Reich who has written widely on the United States political-economy over the last 40 plus years notes that the emerging Republican leadership now contains individuals who have suggested/inferred that current United States governance practice could be replaced by an alternative model for better outcomes. There is a section of the Republican leadership group, including JD Vane, Steve Bannon, Elon Musk, Peter Thiel and other high-tech billionaires, some of whom appear to believe, that the best form of governance is a permanent chairman of the board of a corporation structure allocated the task of governance. Peter Theil, a large doner to the Republican Party, has gone on record as saying "*I no longer believe that freedom and democracy are compatible*." In other words, any constraints on the ability of an individual to grow his or her income and wealth is not freedom and if democracy works to limit this freedom it therefore should be replaced with a system which allows complete freedom to this group.[9] The conclusion that arises is that JD Vance is their nominated leader capable of leading the way to a more desirable system if and when the opportunity arises.

For the United States to become adopt plutocratic structures it would require a significant proportion of the population, though less than a majority would be willing to destroy the existing government structure. Certainly, a proportion of the voters of former President Trump seem to have this view. Why would a significant proportion of the population have this view? An attempt to answer this will be given at the end of this section.

The United States is not a Democracy; It's a Plutocracy

The above threat to the existing United States governance system is designated in terms of the growing influence of anti-democratic forces. This is a bit misleading. Yes, the United States still has the institutional processes of democracy. However, in terms of evaluating the system in terms of who benefits and how it works, the system is a plutocracy.

[9] theguardian.com/commentisfree/2024/oct/03/jd-vance-anti-democracy-movement-leader.

In 2011 the Nobe Laureate economist Joseph Stiglitz described the political-economy of the United States as governance "*of the 1%, by the 1%, for the 1%*". (Source: Vanity Fair May 2011.) Since 2011, the control of the few, the plutocrats, which would also include the leadership of the large corporations if they were not in the 1 per cent, to run things in their own interests has no doubt significantly increased.

The macro statistics which support the conclusion that the United States is a plutocracy is simply the trends in income and wealth distribution over the last 50 years. The United States amongst comparable high-income countries is unique in its extreme allocation of income and wealth to high-income earners. From Table 1.4 In 1990 the 1 per cent of top income earners earned a total pre-tax income that was 15 per cent greater than the total income of the bottom 50 per cent of income earners. By 2022 this superiority had increased to 100 per cent. In Australia the top 1 per cent was 42 per cent less than the bottom 50 per cent. In 2022 the top 1 per cent of income earners had a personnel wealth that was 23 times that of the bottom 50 per cent compared to a ratio of 4.9 for Australia. In terms of the data in Table 1.4 Australia is approximately one-third to half way between the average Western European country and the United States.

Table 1.5 indicates that this relative superiority applies to post-tax income including transfers when pre- and post-tax income inequality is measured in terms of the Gini coefficient. A Gini coefficient of 0 (zero) indicates perfect equality and a value of one indicates that all income goes to the same person.

The relative high Gini coefficient for post-tax income in the United States reflects the weak progressivity of the Federal direct tax system. The top 1 per cent pay an average tax rate of 25.9 per cent in 2021, 23.3 per cent for the top 5 per cent, 21.5 per cent for the top 10 per cent, 18.4 per cent for the top 25 per cent and 16.2 per cent for the top 50 per cent.[10]

However, it's the ability in the United States for the very top income earners, the plutocrats, to minimise tax that is the stand out. G. Leiserson and D. Tagan conclude:

> *"In our primary analysis, we estimate that the 400 wealthiest families paid an average Federal individual income tax rate of 8.2 percent on $1.8 trillion of income over the period 2010–2018, the years from the last decade for which the necessary data are available. Two factors that contribute to this low estimated tax rate include low tax rates on the capital gains and dividends that are taxed, and wealthy families' ability to permanently avoid paying tax on investment gains that are excluded from taxable income."*[11]

This should not be a surprise given the very top income earners' direct support of a significant share of the costs of the United States electoral cycle as described in this section. This gives them first claim on legislation to protect their interests and gives them an adequate return on their investment. The average Federal direct tax rate is 13 per cent.

Another route to directly access the United States plutocratic status is to quantify who benefits from the legislation actually passed by Congress. Princeton University professors M. Gilens and B. Page analysed 1,779 cases, assigning values of between 0 and 10 in terms of the beneficiaries and then undertaking statistical analysis across the entire data base for conclusions. They concluded that the views/interests of the '*average*' United States citizen if in conflict with the plutocrats had little or no influence on outcomes. "*In the United States, our findings indicate, the majority does not rule—at least not in the causal sense of actually determining policy outcomes."*[12]

Table 1.4 Income and wealth inequality: United States and Australia

	Pre-tax income		Net personal wealth	
	United States	Australia	United States	Australia
Share of top 1 per cent of income earners (per cent)				
1990	14.7	7.1	28.6	na
2022	20.9	9.9	34.9	23.9
Share of bottom 50 per cent of income earners (per cent)				
1990	16.9	18.8	1.7	na
2022	10.4	17.2	1.5	4.9

Source: World Income Database.

10 https://taxfoundation.org/data/all/federal/latest-federal-income-tax-data-2024/#:~:text=The%20average%20income%20tax%20rate,the%20bottom%20half%20of%20taxpayers.

11 G Leiserson and D. Tagan What Is the Average Federal Individual Income Tax Rate on the Wealthiest Americans? The White House, 2021.

12 https://www.cambridge.org/core/journals/perspectives-on-politics/article/testing-theories-of-american-politics-elites-interest-groups-and-average-citizens/62327F513959D0A304D4893B382B992B.

Table 1.5	Income and wealth inequality: United States and Australia – Gini coefficient		
	Year	**Gross income**	**Disposable income**
Australia	2020	0.37	0.32
Germany	2020	0.36	0.30
United States	2022	0.44	0.40

Source: OECD.

The instrument of Plutocratic control: The cost of the United States election cycle

According to OPEN SECRETS, an organisation which follows the funding costs and the sources of funding for United States elections, averaging the results from the three elections, 2020,2022 and 2024, the Federal congressional (Senate and House of Representatives) elections cost US$10 billion and the Presidential election US$6.6 billion. In closely contested Senate races, such as for Texas, the total cost will be US$100 million while the cost contested house races will be approximately US$17 million. For this election cycle only 13 members out of 538 members of Congress have raised more than 50 per cent of funding from small doners. Many in this group include high profile members of Congress that would be known to many Australians, such as Bernie Sanders and Elizabeth Warren. The conclusion from this is a large number of members of congress are beholden to a small number of supporters.[13]

Overall, in a presidential election year up to 15 per cent of funding comes directly from the billionaires. However, if account is taken of their funding and influence over other funding and support channels, such as corporations, single issue advocacy entities, direct political support entities including grass roots funding entities, etc. the conclusion would have to be that the political control of the plutocrats would be dominant, which is reinforced by data from OPEN SECRETS which suggests that over the past 20 years "*most money wins between 71% and 98% of the time*".[14]

As would be expected given the steady increase in the plutocrat's economic power their control over the 2024 election cycle has increased. As at the end of October:[15]

- Billionaires have directly donated 18 per cent of the money raised or US$0.7 trillion.
- At least 144 people of the 800 United States billionaires are active in support of either party;
- A third of the Trump campaign funds have come from billionaires and over 25 per cent from just four billionaires including Musk at US$118 million.

Little wonder that the plutocrats now want direct control over policy by occupying official positions in the administration and use this power to further their own interests but also to render their rivals at a disadvantage. In part this may also represent a reaction to President Biden's March 2024 State of the Union speech to try and ensure that such reforms are well and truly off the agenda.

The power of plutocrats arises not just because of resources but because they are willing to coordinate resource use. The same messaging is delivered by each individual in the same media outlet or research institution which is repeated across many such institution replicating an environment, within the partisan bubble, not too dissimilar to that created by Joseph Goebbels in the Nazi political campaigns of the 1930s. The best evidence for this is the fact that a substantial segment of the electorate believes that Donald Trump will make their life better and destroy the other plutocrats making their life a misery. There is no logic to this other than his immigration and tariff policies do give him a degree of credibility which must be enough for them to accept the rest of his messaging.

President Biden's State of the Union Address of March 2024 set out Budget plans for 2025 and contained a number of revenue-raising measures needed to reduce the risk of a bond market crisis. These measures included a minimum 25 per cent tax on billionaires to tax unrealised capital gains, average now at 8.2 per cent, and increase the minimum corporate tax rate from 15 per cent to 21 per cent. This was certainly a step in the right direction and the changes carried into the Democratic Party platform. However, for the election platform the impact on the deficit has been weakened by tax reductions and tax credit expansion, though not for the plutocrats. However, given the complexity of getting legislation through congress the suspicion is that there is an implicit understanding with the plutocrat doners that this is necessary to energise the base and, if legislation is introduction in support of the program, the final form will be significantly less onerous.

This is a clear illustration that markets, not politics, will have to take the lead in the stabilisation of United States public finances.

13 https://www.opensecrets.org/elections-overview/cost-of-election.

14 https://www.usatoday.com/story/news/politics/2022/11/03/midterm-elections-campaign-contributions/10653419002/.

15 A. Rogers and E. Xiao "*Battle of the billionaires: the mega rich spending to swing the US election*", Financial Times, 26th October 2024.

What institutional changes are required to restore effective democracy in the United States?

Basically, if the objective is to restore effective democracy in the United States many of the reforms would follow the Australian model.

(1) Political contribution transparency and constraints, though a bit tougher than Australia.

(2) Proportional and preferential voting (two United States states have this) to break the chokehold of the two major parties.

(3) Compulsory voting to limit practises to alienate groups from the political process.

(4) An independent commission to draw electoral boundaries.

(5) Increase the number of senators from each state to four or more to allow greater diversity of views.

(6) Direct voting for President on a national basis.

This system would quickly allow the destruction of one or both of the two political parties if they failed to reconnect with mainstream views and be replaced by parties and independents which do.

Chance of this happening via normal political process – zero. A period of extreme political-economy disruption is going to be required to achieve it with the risk that from this disruption a more autocratic model may be the winner.

What would be the motivation of Vance et. al. for replacing a defacto plutocracy with a dejure one?

For a single plutocrat to pay out US$50 to US$100 million each election cycle would be tiresome no matter how rich. It would represent a substantial implicit tax that may well be greater than the direct tax rate for which these expenditures are being made to maintain or achieve.

There is also the problem that plutocrats are in competition with each other especially if the Government came under fiscal pressure. Much simpler to limit the plutocracy to like mined individuals with common interests, and certainly those who know the future and how to get there.

Finally, there is the issue of the bond market meltdown. Having successfully 'starved the Beast' they would well know it's coming and it's their fault. A sensible strategy would be when the turmoil begins to have all the narratives in place to blame it all on democracy and the Democrats argue a new system is required. The new system would allow the plutocrats to impose heavy indirect taxes, tariffs and social security reductions without any major income reductions to themselves.

How all this will be done is not clear and would depend on the actual circumstances, the degree of legitimacy in the community for change by the proponents of change and what can be done after a President declares a declaration of emergency which appears quite opaque.[16]

What is clear is that the maintenance of the illusion that the United States is a functioning democracy is of strong assistance to those who wish to ensure that it never will be one.

1.4.2 The United States health system: An outcome of plutocratic rule

In a plutocratic governance structure, a core objective is to shift taxes from direct to indirect taxes and indirect taxes in specific rather than ad valorem terms. Ad valorem terms is when the tax rate is levied as a per cent of the value of the good or service while specific indirect taxes are a fixed absolute amount against a unit of a good or service. Plutocratic real disposable income for a given public sector expenditure level is maximised when government revenue consists of specific indirect taxes. The French nobility got close to this ideal in 1788. A substantial part of United States health care costs, that is the part funded by the employer, are a straight specific defacto indirect tax on employment. In this context it is not surprising that tariffs, a form of ad valorem indirect tax, are being proposed by the Republican Party. This allows the tax rate on high incomes to be reduced at a cost that will disproportionally be paid for by the bottom 50 per cent of income earners.

Since the Great Society program of the mid-1960s which extended direct government support for health care of the 65 plus age group, the plutocrats have forcefully opposed any further extension towards a single payer system, although some marginal gains were achieved under Obamacare and temporary gains in the COVID-19 era. That is, where a single (or group) of public authority funds health care using general taxation revenue as is common in non-United States OECD countries. This opposition is driven by the objective to minimise direct taxes on their incomes. However, as is pointed out below, there is another reason. The plutocrats have turned the United States health care system into a wealth pump to maximise their extraction of income from the general economy.

[16] Source https://www.brennancenter.org/our-work/analysis-opinion/what-president-could-do-if-he-declares-state-emergency.

As a result, what has been created is a system that defies description in terms of its unsatisfactory outcome. Perhaps all that needs to be done is to quote Case and Deaton:

> *"… it makes good sense for rich countries to spend a large share of what they have to extend their citizens' lives and to reduce pain and suffering. But America does this as about as badly as it is possible to imagine."*[17]

What is the situation.

For the working age population mandatory employer health cover is available if you work in an enterprise with more than 55 full-time employees and you are a full-time employee. As a result, about 40 per cent of employees are not covered and rely on the Government scheme. Then there are the millions not in the workforce/unemployed etc. covered by a patchwork of measures that generally fall well short of desirable. For those covered the average annual premiums in 2022 were US$7,911 for a single cover and US$22,463 for a family cover.[18] Workers with health cover on average were responsible for 17 per cent of the single premium and 29 per cent of the premium for family cover. Therefore, the average contribution for covered workers was $1,401 for single workers and $6,575 for family coverage.[19]

Why households with employer health care can get into financial difficulties is because plans can vary greatly in terms of items covered, copayments and deductables, or the amount that has to be paid before the plan pays the medical bills. In 2024 the average deductable is estimated at a little over US$3,000.[20]

Further, those eligible for Government health programs face high expenses. Medicare households, including 59 million households aged 65 and over and 7 million households with disabilities under 65, can also have substantial health care cost problems. According to one estimate in 2022, Medicare households spent an average $7,000 or 13.6 per cent of average total household spending.[21] This is because under Medicare many costs and services are not covered, while additional premiums, deductibles and copayments increase the beneficiaries' costs. This is a case of social policy of giving with one hand and taking a large portion away with the other.

The other major Government program is Medicaid which is a joint Federal-State program for the poor. In 2022 it covered 90 million people. Depending on the State this too can have substantial out of pocket expenses, if in absolute terms less than Medicare, but a high burden relative to income.

With such diversity in individual cases the only satisfactory way to measure outcomes is via a survey of participants. The Commonwealth Fund in the United States conducts this type of survey of the coverage of the United States health care industry. Their latest survey in mid-2022 had a sub-sample aged between 19 and 64. The headline results for this group were as follows.

- Forty-three per cent of working-age adults were inadequately insured in 2022. These individuals were uninsured (9 per cent), had a gap in coverage over the past year (11 per cent), or were insured all year but were under-insured, meaning that their coverage didn't provide them with affordable access to health care (23 per cent).
- Twenty-nine per cent of people with employer coverage and 44 per cent of those with coverage purchased through the individual market and market places were under-insured.
- Forty-six per cent of respondents said they had skipped or delayed care because of the cost, and 42 per cent said they had problems paying medical bills or were paying off medical debt.
- Half (49 per cent) said they would be unable to pay for an unexpected $1,000 medical bill within 30 days, including 68 per cent of adults with low-income, 69 per cent of Black adults, and 63 per cent of Latinx/Hispanic adults.
- Sixty-eight per cent of Democrats, 55 per cent of Independents, and 46 per cent of Republicans said President Biden and Congress should make health care costs a top priority in the coming year.[22]

The last dot point is further evidence that the plutocrat's view on health care is at odds with the mainstream.

There are substantial financial costs for those without adequate health cover. In 2021 a government survey estimated medical debt in the United States was US$220 billion with 14 million people owing over US$1,000 and three million owing over US$10,000. Other studies estimate that: "*More than half of adult Americans (56%)*

17 Anne Case and Angus Deaton Deaths of Despair and the future of capitalism. Princeton University Press Princeton and Oxford 2020.

18 https://www.kff.org/report-section/ehbs-2022-section-1-cost-of-health-insurance/.

19 https://www.kff.org/health-policy-101-employer-sponsored-health-insurance/?entry=table-of-contents-how-much-do-workers-contribute-towards-the-premiums-for-employer-sponsored-health-insurance.

20 https://www.kff.org/affordable-care-act/issue-brief/deductibles-in-aca-marketplace-plans/.

21 https://www.kff.org/medicare/issue-brief/medicare-households-spend-more-on-health-care-than-other-households/#:~:text=Medicare%20households%20spent%20an%20average,74%2C100)%20(Figure%201**).**

22 https://www.commonwealthfund.org/publications/issue-briefs/2022/sep/state-us-health-insurance-2022-biennial-survey.

have some medical debt and a nearly quarter of the population (23%) owe more than $10,000".[23]

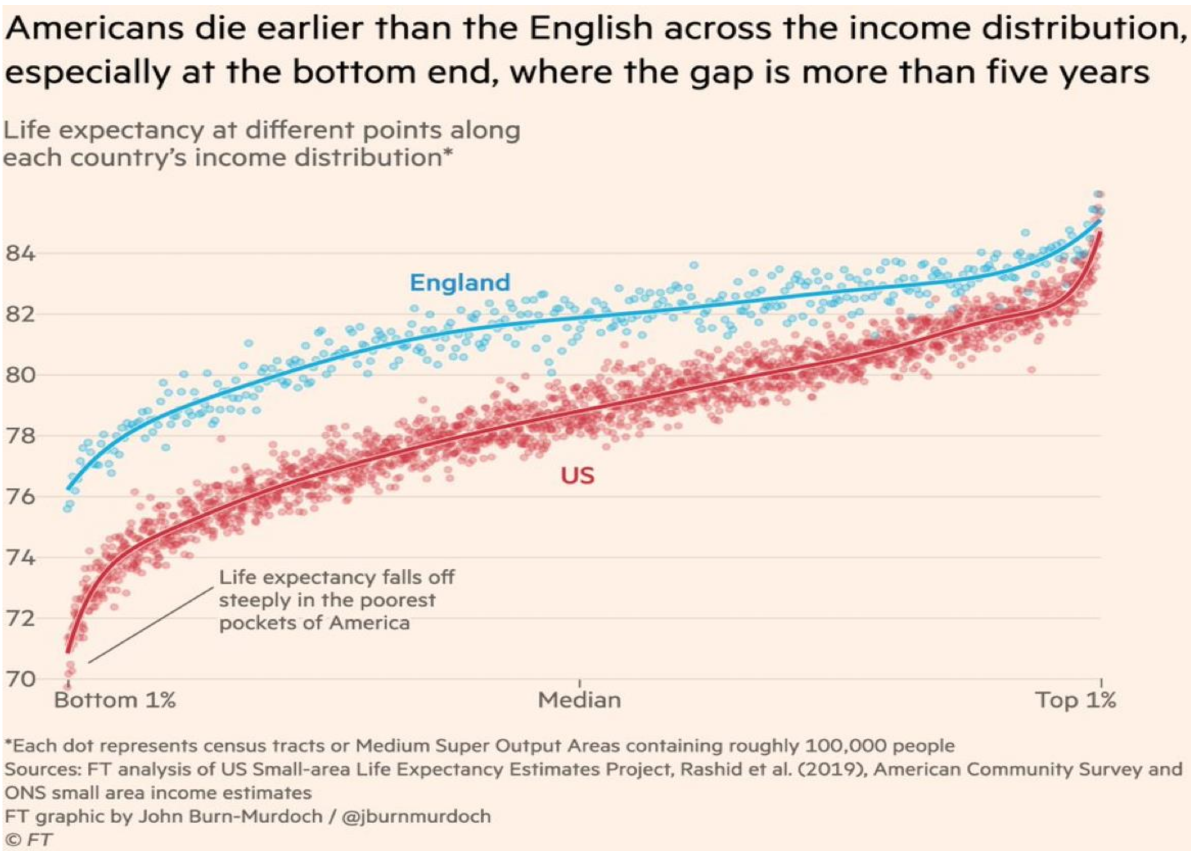
Another study claims that because of this:

- 40 per cent of Americans fear they won't be able to afford health care in the upcoming year;
- 17 per cent of adults with health care debt declared bankruptcy or lost their home because of it;
- 66.5 per cent of bankruptcies are caused directly by medical expenses, making it the leading cause for bankruptcy; and
- as of April 2022, 14 per cent of Americans with medical debt planned to declare bankruptcy later in the year because of it.[24]

Another study reports that 62 per cent of the approximate two million personal bankruptcies filed each year are the consequence of medical debt.[25]

The greatest cost, however, is simply that people die early in great numbers compared to a country with a single payer health system, in this case the United Kingdom, as is shown in Figure 1.4. The life expectancy gap at the very bottom of the distribution is six years. However, even at the medium income levels of the distribution the gap has only halved to a little over three years. The gap only rapidly closes over the top 10 per cent of the income distribution. Over the COVID-19 period, where United States life expectancy fell significantly more than its peers, the gaps would have widened. In 2022 United States life expectancy was 77.3 compared to an average of 82.2 for comparable countries. This is still well down compared to the pre-COVID-19 level of 78.8 which was also not the experience of comparable countries.[26]

Figure 1.4: Americans die earlier than the English across the income distribution



[23] https://www.usatoday.com/money/blueprint/debt/can-medical-bankruptcy-help-with-medical-bills/.

[24] https://www.retireguide.com/retirement-planning/risks/medical-bankruptcy-statistics/.

[25] https://www.abi.org/feed-item/health-care-costs-number-one-cause-of-bankruptcy-for-american-families.

[26] https://www.healthsystemtracker.org/chart-collection/u-s-life-expectancy-compare-countries/#Life%20expectancy%20at%20birth,%20in%20years,%201980-2022.

It is clear from the above statistics that for many in the United States life is, in relative term, is poor and short, or in Case and Deaton terminology, is characterised by "*deaths of despair*" compared to other comparable countries. In part this is because of the United States health system. The question is how much? Many cultural factors affect life expectancy including lifestyle, gun culture, attitudes to drugs etc. However, there will be second round impacts. The failure of the United States health system to provide an expectation of a reasonably healthy and secure life must also impact on the development of unsatisfactory United States lifestyle and cultural features with a heavy weight given to the benefit of current activities and a low weight given to the consequences of current activities for the future. Also, what should be taken account of here, is the impact of the health care system on the creation of the "*jobs of despair*" for low-income earners as is explained in the next section. The failure of the United States to adopt a single payer health system, adequately resourced, will not explain all of the differences in life expectancies in Figure 1.4. However, once all feedback loops are taken into account, it would explain a large part of the problem.

1.4.3 Other ways the United States health system contributes directly to "*deaths of despair*" via its impact of creating *"jobs of despair"*

Access and quality of access is but one way the United States health system contributes to premature deaths in the United States.

Major channels for this outcome are:

(1) it destroys jobs and turns reasonably paying jobs into poor paying jobs;

(2) it's highly inequitable in terms of who pays for health care; and

(3) the costs of health care are at least one-third more than what they should be which affects access but also reduces the real incomes of all bar the large gain in income for the top 10 per cent who directly benefit from the excess cost. That is, the health care system has been designed as a wealth pump by and for the plutocrats and nearby high-income earners.

Destruction of jobs and quality jobs

By way of background, the Federal minimum wage in the United States is $7.25 an hour and at 1,800 hours of work a year translates into $13,050 a year income, which is a little above the poverty line for a single member household of $12,880, itself not a living wage. The medium annual wage and salary in the United States is around $75,000.

For full-time employment positions in the US$20,000 to US$30,000 range in enterprises mandated for health care cover, the $5,000 to $18,000 health care costs (after copayments and including potential family costs) is not an economic proposition, as they represent up to 90 per cent of the direct wage costs. The response of employers would be to eliminate the so-called entry level positions and either turn them into part-time or casual positions, or outsource the work to the self-employed or to enterprises not eligible for health care cover. For higher paid employment the incentive for employers to reduce $ per hour wages to recoup the medical cover costs is strong. Under this incentive employment positions that would have been closer to $40,000 under a single payee health cover scheme become employment positions closer to $30,000, with this process repeated up the pay scale, especially for those occupations where there is an excess supply of labour. For high paid employment positions, for example, US$300,000, the incentive to do this is weaker since the 'indirect tax' represents a maximum of 6 per cent of direct labour costs.

It is this dynamic that underlines the assessment of Case and Deaton op. cit. that under the United States medical system:

> "*The cost of employer-provided health insurance, largely invisible to employees, not only holds down wages but also destroys jobs, especially for less skilled workers, and replaces good jobs with worse jobs*."

That is, the United States health care system is an important explanation for the fall in the income share of the bottom 50 per cent of income earners, Table 1.4, going from 16.9 per cent to 10.4 per cent between 1990 and 2022, when the increase in employer coverage is taken into account along with the relative increase in health care costs.

In summary, the United States health care system is a major contributor to the creation of "*jobs of despair*", long hours, low paid employment with poor career path prospects, that directly and indirectly feeds into the "*deaths of despair*".

Extreme inequality in who pays for health care

For those with health cover there is extreme inequality in who finally pays for the health cover. Because it's more or less a specific tax, that is a fixed cost, the average deductables of US$3,000 represents 10 per cent of and income of US$30,000 and 1 per cent of an income of US$300,000. The same outcome will be the case for copayments.

However, what is most unfair is that because the costs of the employer component of health care insurance costs are paid for by employers increasing their goods and service prices. Two families, one with employer health cover and one without, and with the same income/expenditure pattern will pay exactly the same towards the total costs of health cover, although one family will not have any benefit from the employer schemes. The uncovered family will be penalised by multi-thousands of dollars via the goods and services they purchase. Again, the same mechanism operates with high-income households paying a much smaller percentage of their income for these costs compared to low-income families. This is yet another way the health care system immiserizes the bottom 50 per cent of income earners to the benefit of the top income earners, given that the alternative would be higher taxes on the latter incomes.

United States health care spending as a wealth pump

In 2022, United States health care spending was US$4.5 trillion, or 17.3 per cent of GDP. The average of comparable countries, Western Europe, Australia, Japan, is 11 per cent. This gives the United States an excess spending rate of 6.3 per cent of GDP, or US$1.6 trillion. Despite this expenditure the United States has a poorer life expectancy outcome than that of the comparable countries. Up to six years for countries such as Switzerland.

A large part of the US$1.6 trillion is the result of system design that operates as a wealth pump for the plutocrats and nearby income groups.

The drivers of the wealth pump

The key drivers of the wealth pump,[27] largely justified on the principal that free market capitalism is optimal, are:

(1) weak or no regulation of service charges;

(2) weak or no targeting/rationing of expensive equipment or specialist use for the most appropriate use resulting in large over-provision of these services compared to comparable countries;

(3) weak or no control over drug prices;

(4) once approved no body exists as in other jurisdictions to determine which is the best drug/procedure for a given objective. Marketing campaigns therefore drive the over-use of inefficient drugs/procedures;

(5) in some States no restrictions on hospitals buying other hospitals to provide monopoly services for a given catchment with price gouging at a high level occurring;

(6) weak or no regulation of hospital charges mean prestigious or well marketed hospitals charge multiple times less prestigious hospitals for the same service;

(7) high involvement of the general finance industry, including private equity in the health care industry, means that opportunities for margin increases are quickly exploited;

(8) high fragmentation of insurance providers creates high administrative costs with high administrative costs including high payments to certain personnel; and

(9) high involvement of the legal industry resulting in a higher probability of malpractice suits compared to other jurisdictions. This encourages over-servicing as a defensive measure.

The excess costs of the United States health system represent a cost levy of US$12,598 for the United States 127 million households, or 17 per cent of the medium household income. For most of United States households this cost represents a direct payment to the relatively small number of households that benefit from other direct income or via financial income from the wealth pump.

In 2026 the best way to solve the bond market meltdown would be the introduction of a single payer health system. The fiscal savings resulting would go a long way to reducing the deficit to a desired level. How? The introduction of a single payer health system offers the benefit of expenditure savings of US$1.6 trillion so that an indirect sales tax to replace the employer costs would still result in substantial increases in real disposable incomes for most United States households. Government direct expenditures on health would also fall reducing the deficit. The residual to close the deficit would be obtained by increases in the effective tax rates on the high-income groups. That is the deficit problem could be solved with substantial real income gains for the bottom 50 per cent.

There have been many attempts to reign in health costs. As would be expected in a plutocracy. dominated legislative is undermined by what legislation is acceptable and the design of the legislation that is passed. A large number of lobbyists work to ensure this outcome. In the end, the system will collapse under its own excesses if the excesses don't lead to the collapse of institutional governance structure first. "*At the current pace, U.S. healthcare expenditures may reach $8 trillion by 2035, more than 20% of forecasted total U.S. gross domestic*

[27] Case and Deaton, op. cit. harvardmagazine.com/2020/04/feature-forum-costliest-health-care jamanetwork.com/journals/jama/full article/2785479.

product. "[28] Without root and branch reform the system has unfettered capacity to grow its claim on GDP faster than GDP growth and therefore continue to further immiserize increasingly larger segments of the United States population.

1.4.4 Education and science

The decline in United States education standards is illustrated by the following[29] metrics.

- Continued decline in college admission test standards with 70 per cent of high school students not meeting math college readiness benchmarks and 43 per cent not meeting college readiness benchmarks in anything.
- The United States now ranks 34th in the world in math proficiency.
- Ten years ago, the United States produced by far the most highly cited scientific papers in the world and has now been displaced by China.
- In 1980 four-fifths of computer science and electrical engineering doctorates went to United States residents. It is currently less than a third.
- Federal Research and Development expenditure to 0.7 of GDP compared to just under 2 per cent in the 1960s. This compares to 1.3 per cent for China.[30]

In average PPP dollar terms, China's spending on R&D is now 65 per cent greater than that of the United States, or US$0.53 trillion greater, and no doubt considerably higher again if specific PPP rates are used.

In the context of reducing government functions (and reducing the plutocrats' tax burden), the Republic Party platform for the 2024 election is to abolish the Federal Department of Education, which encourages best practice teaching methods and covers approximately 10 per cent of set school education costs. This level of funding is nowhere near enough to offset inequalities in school funding as indicated by the data in Table 1.6. The United States education system is now designed to preserve the power of the families of the existing plutocrats well into the future.

Table 1.6 United States: Inequality in school funding – assessment of local school funding adequacy based on income

Individual income	Per cent who rated local school funding as sufficient, very good or good
Less than US$25,000	31
US$25,000 to US$74,999	44
US$75,000 to US$199,999	58
US$200,000 or more	71

Source: Peter Lampl, "*Unequal school funding hobbles the American dream*", Financial Times, October 2024.

The higher the individual income the more likely an individual will live in an equally high-income region with high property taxes and, therefore, higher funding for local schools.

The main route to improving United States school education outcomes and to increase intergenerational equality is to increase funding from the central government to reduce the current inequalities. The Republicans want to do the reverse and the Democrats do little to change the status quo.

1.4.5 The states of the United States: The race to the bottom

Another cancer undermining the resilience of the United States political-economy is the fiscal policy settings of the States. In Australia and many other comparable jurisdictions strong central government tax revenues which allows resources to be allocated to the regions in a manner that encourages growth in lagging regions but also minimizes the impact on growth prospects of the more successful regions. The weak revenue raising potential of the United States Federal Government prevents this. As a result, weak/small lagging states have little ability to improve their rankings while larger states such as Florida and Texas compete by abolishing income taxes and replacing them with indirect taxes with its direct impact on the distribution of real incomes, so as to attract the wealthy, skilled households and corporations from the successful states such as California and New York thereby undermining the latter's medium term growth prospects. It will also force more States to abolish income taxes and

[28] https://www.lek.com/insights/hea/us/ei/looking-ahead-us-healthcare-provider-landscape-2035#:~:text=At%20the%20current%20pace%2C%20U.S.,a%20lower%20per%20capita%20cost.

[29] Amy Zegart, "The Crumbling Foundation of American Strength", Foreign Affairs, September/October 2024.

[30] https://sciencebusiness.net/news/international-news/us-holds-china-challenge-global-rd-spending-race#:~:text=It%20shows%20that%20the%20US,China%20spent%20%24668%20billion.

"continue the race to the bottom". Eventually the limited fiscal capacity of states such as Texas and Florida will strangle their growth prospects by the under-provision, relative to population growth, of infrastructure, education attainment, skills formation and a poor social environment so that the whole country is worse off but the plutocrats' objective of ever increasing the redistribution of income in their favour achieved by the substitution of indirect taxes for direct taxes.

It's difficult not to conclude that Case and Deaton's comment that the design of the United States health system is the worst possible also applies to many other aspects of the United States political-economy. The Soviets, or at least Gorbachev, over 1985-1990 recognised that their design of a socialist economic system was the worst possible compared to the Chinese design and tried to move, too late, towards the Chinese version. The United States has not moved to first base in this regard. The end point of the current United States design is de jure plutocracy given that there is nothing to stop their ever-increasing economic power. The crisis arising from the bond market meltdown will probably provide the last opportunity for reform to avoid this fate. To be successful the reform will have to be root and branch. A common theme running through the issues discussed above is the loss of resilience from the lack of a strong Federal tax base.

1.4.6 The explanation for the development of extremism in the United States

For the disadvantaged groups in society, including ethnic groups, the Democratic Party was the party of choice in the hope of a degree of advancement. After waiting decades and seeing increasing despair many in this group, understandably, lost patience and voting support has steadily switched to the Republican Party, on the logic of many no doubt, "*I could not be any worse off and I will damage those who let me down so badly*". That logic could well be tested over the next four years.

Amongst this group that on the basis that their life is poor and short, with escape routes such as education being steadily degraded, it is little wonder that there is a strong motivation to destroy the system and are attracted to individuals who promise to destroy the system. They would realise the system is killing them before their time so a violent reaction is to be expected.

In retrospect, it was a mistake for the Clinton and Obama Administrations not to have undertaken large-scale redistribution of income policies and 'starve the beast' before their Republican opponents did it to the benefit of the plutocrats. However, this was impossible as the Party's plutocratic controllers would not have allowed it as their objectives were 'sound finance' policies which allowed them to make billions from the finance sector. The cost of this for the United States political-economy has decades to run.

This of course is in keeping with the answer to the question posed at the beginning of this section. That is, the resilience of the United States political-economy is poor. The probability that the base case scenario outlined is achievable must be rated significantly less than 50 per cent.

It's often the case the worst predictions happen are proved to be the case just after they are made.

So, it's likely to prove the case for the Economist. In an article, October 2024, discussing United States inequality it concludes: "*The striking thing is how little these problems seem to have exacted an economic toll. Once inequality reaches very high levels, rent-seeking by elites imperils economic growth. America's experience suggests that it remains on the right side of this threshold*".[31]

The statement is wrong now. Rent seeking by the plutocrats may lead to the outcome where in a few days an autocratic intent government may be elected.

1.5 Probability assessment and alternative scenarios to 2040

The current base case assumed that after one year of high economic cost, all the decisions are made to place the United States on a long-run sustainable footing without major reductions to defence expenditures. This allows the 2030 decade to have relatively normal outcomes, as set by the historical record. From the analysis in this chapter it is now clear that the fiscal reforms must also include a movement to a single payee health system, if not in 2027 than by the early 2030s, although the fiscal savings from these reforms may well have to be discounted back to 2027 to obtain resolution of the crisis in 2027, along with greater involvement of the Federal Government in policies like education. Alternative scenarios are outlined below.

1.5.1 The world footprint of the United States security umbrella contracts like the Soviet Union

In 1985 the Soviet Union's public sector deficit as a per cent of GDP was 2 per cent. Then a combination of factors, including the fall in the price of oil, the decline in

[31] https://www.economist.com/special-report/2024/10/14/is-higher-inequality-the-price-america-pays-for-faster-growth.

economic activity from the anti-alcohol campaign, and the increase in Soviet defence expenditure to compete with President Reagan's Strategic Defence Initiative, led to the deficit in 1990 reaching more than 10 per cent of GDP. Between 1980 and 1988 President Reagan increased the United States defence expenditure from 4.9 per cent of GDP to 5.8 per cent.

The Soviet Union collapsed because the regime did not consider it had the authority, because of past failures to improve productivity, to impose the draconian measures needed to bring the deficit under control and maintain the expenditures necessary to keep the Soviet Union as an entity.

China is now applying the same pressure to the United States and could well, as noted earlier, increase that pressure. As the plutocrats will remain in control through the forthcoming bond market crisis, they could refuse to increase their taxation rates to maintain United States defence expenditures to be competitive with China, thereby forcing a substantial reduction in defence expenditure and as a consequence a collapse in at least some of the United States security arrangements.

Just like the collapse of the Soviet Union security umbrella did not apply to all entities, the Russian Federation remained covered if not the Eastern European countries. The same will be true of the United States collapse. What countries would still be included? It's difficult to see countries like Japan and South Koea remaining included. Europe may remain included provided they agreed to build up their defence expenditures quickly and reach 4 to 5 per cent of GDP by the early 2030s.

Countries which lose their United States security umbrella would face depression economic prospects. That is, one where at best there is zero economic growth over five years. Their status would become, at best, defacto Chinese protectorates. Little foreign capital will be attracted to these countries, other than Chinese capital and non-Chinese foreign capital would attempt to exit. The domestic incentive to invest in the local economy would sharply decline as residents attempted to shift capital offshore or simply hold liquid capital in the face of high uncertainty.

To stabilise their economies, Japan and South Korea may achieve light de facto protectorate status not unlike Finland vis-à-vis the Soviet Union. Indeed, the Chinese security regime will probably be based on the United States Monroe doctrine for Latin America, where intervention in affairs will be restricted to where economic or security interests are threatened. Between 1898 and 1994 the United States intervened 41 times in Latin American countries, of which 17 involved military forces.

Because of Australia's low population to land ratio, geographical position and mineral wealth it is difficult to see Australia easily achieving this status with China. Like the autonomous regions of China, Inner Mongolia, Xinjiang, and Tibet de jure protectorate status would allow permanent control to be established over two to three decades of high immigration and permanent military occupation. What outcome occurs will depend on the residual power of the United States and the role of Europe. China needs to trade with the world and it would be useful for China to have Europe as a strategic partner, which would also be the case if Europe did not remain under the United States security umbrella and willing to trade off United States trade and foreign investment for Chinese trade and foreign investment. This may give Australia some wiggle room leveraging its critical mineral status. Also, Finland achieved its status not because it could defend itself against the Soviet Union but because it was willing to impose high costs on the attacker. For Australia, if it's not futile or too late, there is maximum urgency to build up an effective independent defence capacity as quickly as possible. As in the Second World War those with the highest stake in the political-economy should pay the cost. Wealth taxes should be introduced to fund such a program.

During the bond market crisis, it may be that to maintain United States involvement in security arrangements its allies may have to threaten neutrality, or even security arrangements with China. A rapidly contracting United States security footprint would do fundamental damage to its own security, especially given China's '*mind-boggling*'[32] advances in space defence. There is a noticeable growing sense of panic amongst United States military personnel.

At best the outcome of this scenario would be the world would be unlikely to gain more than 1.0 to 1.5 per cent between now and 2040. For the so-called Western World, growth would be very low with those countries absorbed into the Chinese trading block growth may be higher than the base case.

1.5.2 The United States becomes an de jure plutocracy

The following necessary conditions would probably have to be in place for this scenario to be realised.

(i) the bond market crisis extends over two to three years with declining GDP;

(ii) the United States President would have to be a Democrat, which is the best argument for the election of Donald Trump in 2024. When the crisis

[32] A. Hancock "US Space Force warns of 'mind-boggling' build-up of Chinese Capabilities'' Financial Times, 1 November 2024.

hits, he hopefully would lose legitimacy as fast as Liz Truss in 2022;

(iii) the media abandons all responsibility to educate the public as to what are the issues and who is to blame;

(iv) a decline in United States security umbrellas and a crisis such as a successful Chinese probably bloodless invasion of Taiwan with immediate loss of United States prestige and self-confidence;

(v) a severe retaliatory trade war with rounds of increasing tariffs; and

(vi) the Western World as a whole falling into depression.

The outcome of this scenario would be the world economy would be unlikely to grow more than 0.5 to 1.0 per cent between now and 2040 as it would have at least as bad economic outcomes as the previous scenario. As with the other cases this would be associated with large falls in economic activity 2026-2033 followed by some recovery. The non-western World growth rate may well accelerate from the base case.

1.5.3 Rolling crisis

If the 2026-2027 crisis is resolved by a combination of less than satisfactory policy changes and some vague promises to do more in the future and the finance markets accept this. The growth profile for 2025-2031 given in the above table would still be possible. However, another crisis would be inevitable by 2032, perhaps followed by another towards the end of the 2030s. Over the 2030s world economic growth would be restricted to around 1.5 to 1.8 per cent per annum.

1.5.4 The high scenario

The high scenario would be one where the crisis is resolved quickly in 2026 with the implementation of major fiscal and institutional reforms, with the fiscal policy requirements largely financed by the introduction of single payer health reform. The probability of this happening is, for many reasons listed above is small.

1.5.5 Scenario probability rankings

Given the assumption that the five scenarios given above define all possible outcomes, then the assigned probability rankings are:

		Probability
1.	Base case	35
2.	Contraction in United States security umbrella	20
3.	The United States becomes a de jure plutocracy	15
4.	Rolling crisis	25
5.	High scenario	5

Scenario three would also involve collapse/contraction of the security umbrella. The reader can make his or her judgement as to probabilities. Normally the base case has a probability of 50 per cent or greater. Given the poor status of the United States political-economy, it is not possible to assign this probability to the current base case. However, it is perhaps possible to assign a probability near 50 per cent to the combined base case and rolling crisis scenarios.

The American influence on Australia: From the Australian settlement to incipient plutocracy

In 1901 Australia became a federal Commonwealth – an interesting choice of identity, with echoes of the 17th Century English revolution, not to speak of the choice the Pilgrim Fathers made in 1606 to call their new American colony the Commonwealth of Massachusetts. Australia's Identity as a Commonwealth has become unfashionable in recent years, ironically associated with the idealisation, by many Australians, of different, less egalitarian elements in the American tradition.

The Australian settlement

In Australia, federation took place after the Eastern states had endured a decade of depression. The depression had been a work of private enterprise: enterprising financial institutions borrowed overseas to speculate in residential land development, particularly in Melbourne. This came unstuck in a welter of financial panic. However, during that same decade the previously small and isolated Swan River colony experienced Australia's last major gold rush, which attracted sufficient migrants from the East to swing the vote to join the federation.

The new federation, having chosen its name, set out to fill out the details of its identity. It was assumed that it would be British, and to this end immigration from the United Kingdom was encouraged, immigration from other European countries and from North America tolerated, immigration from Africa or Asia strongly discouraged and the Aboriginal presence ignored. The emphasis on British migration failed to generate the desired cultural homogeneity – the Irish among the immigrants saw to that.

As an essential step in building a Commonwealth, there was to be a settlement between Capital and Labour, presided over by a paternalistic government. The settlement relied on government leadership in economic development, including reliance on public enterprise for a variety of infrastructure services. Agriculture – which was the main export industry until the 1970s – was to be supported by infrastructure, marketing and research services. Manufacturing was to be developed, primarily to generate jobs but also to diversify the economy. Established industry policies, such as infrastructure support and government purchasing preference, were continued at state level. There was to be free trade within the Commonwealth, but employment-generating infant industries were to be protected. There would also be a basic social welfare safety net, financed from progressive taxation. The finance sector, chastened by its recent bad behaviour, was to be regulated and managed conservatively. Capital and Labour were to adjudicate their differences through government-provided Arbitration. Though not socialist, the ethos was to be egalitarian.

The Keynesian revolution in economic theory arrived from the United Kingdom in the late 1930s and was found to be remarkably compatible with the Australian settlement. The three decades following the end of World War II were characterised by rapid population growth (with immigration from a gradually broadening range of countries), rapid economic growth (as judged by income per capita) and full employment, which at that time meant that a man who lost his job was generally back at work within six weeks. However, the Commonwealth government, which during World War II had developed a detailed knowledge of industries and their supply chains, failed to keep this knowledge up to date or to integrate it into macroeconomic management.

It was all too good to last, and in the 1970s much of the distinctive Australian Settlement fell apart. The reasons are numerous. To begin with, by the 1970s Britain was no longer a major world power. Did Australia want to linger as a relic of a past empire, or did it want to become culturally American and so associate itself with the new superpower, or did it wish to strike an independent course involving much closer relations with Asia? As regards the privately-owned media and much of Business, there was no choice but to Americanise.

The American influence

Australians have long had friendly relations with their 'cousins' across the Pacific. However, there were nuances to the relationship. The colonies which federated as the United States spoke English as a relic of their British foundation, but they forswore British allegiance. Half of them had been commercial plantation colonies dependent on slave labour and the other half had been settled by religious groups seeking freedom from persecutions real or imagined. They had abjured the inequalities of aristocracy but remained inegalitarian, most obviously through the institution of slavery. The civil war which attended the legal abolition of slavery served to entrench racial inegalitarianism. When the Australian colonies turned to public enterprise to provide such infrastructure works as railways, the United States depended on robber baron capitalists, entrenching economic inequality.

Given these divergencies of heritage, it should not surprise that the Australian Settlement of the early 20th Century diverged from its United States counterpart – not completely, for both ignored their indigenous peoples, restricted Asian immigration and featured tariffs as a major industry policy. However, the United States did not resort to public enterprise as an instrument of economic development, nor did it allow a major role for trade unions. It was reluctant to provide a social safety net, particularly in health services, and loath to restrict the freedoms of its financial institutions. Enterprising speculation in the United States financial sector contributed mightily to the 1930s depression.

In economics, Keynesian macroeconomic ideas penetrated the United States shorn of their microeconomic underpinnings. In the 1950s the sinuous supply chains and the combinations of good and bad information, optimism and pessimism, competition and monopoly, which underlay Keynesian macroeconomics were swept aside as the American academic establishment concentrated on strengthening the defence of Capitalism against Communism. A defence originally developed in the 19th Century was updated by including what looked like microeconomic detail – industries were distinguished, but there were no economies of scale or agglomeration, nobody was led astray by uncertain information and competition was universal. The result was an exceedingly elegant but highly abstract theory which showed that, under a long list of conditions, economies composed of competing capitalist businesses would yield an 'optimum allocation of resources', that is, a distribution of production and incomes which was arguably the best attainable, given the initial distribution of wealth. Needless to say, there were arguments. Was the existing distribution of wealth desirable? Was the list of conditions approximately correct or did it generate totally misleading results? These arguments gained no traction, given that the wonders of competition were so well attuned to the ideological needs of the day.

The United States has a long tradition of evangelism and Americans can be very persuasive in spreading their ideologies. Several factors helped to introduce Australia to the American neoliberal ideas which undermined any attempt to extend the Australian settlement into an independent platform, from which engagement with Asia could be pursued. To begin with, there were domestic business interests which rallied to the defence of competitive capitalism. In particular, the pastoral industry, which during the post-war period supplied Australia's chief export, chafed under the impact of tariffs, complaining that they raised its costs. The pastoral industry sought allies in its attack on tariffs, most audaciously seeking to recruit the Australian consumer in its campaign. To this end, the latest in American economic theory proved very useful. Tariffs tilted the terms of universal competition, and their removal would benefit consumers. This argument was promoted by specifying and estimating a Computable General Equilibrium model of the Australian economy. This approach to policy assessment was supported by a new generation of career economists returning with PhDs from prestigious United States universities. The anti-tariff campaign succeeded and tariff rates fell consistently from 1989 onwards. The effects of the fall on the protected industries were, at first, cushioned by industry policies such as marketing assistance, but these were cut back from the late 1990s on. The social welfare system was left to deal with a substantial cohort of deskilled, middle-aged manufacturing industry workers.

The glorification of competition

In neo-liberal theory competition appears as a benign, almost friendly force which ensures that producers respond to consumer demands. Producers include workers, who compete for jobs, and businesses, which compete to organise labour and other inputs as well as to sell the resulting goods and services. Though neo-liberal theory was first used in Australia to support the case for free trade, in due course it became the basis of a program of microeconomic reform. While they asserted that the neo-liberal theory gave a broadly accurate account of the relationships between industries and between labour, business and consumers, the reformers noticed differences between Australian industry organisation and the competitive ideal. More practically, they took the United States economy as their paragon – So productive! So efficient! – and worked to replace Australian structures with American. Two features attracted reform.

First, public enterprise as a means of dealing with economies of scale and more generally in managing industries with high positive spillover benefits had never been tried in the United States (outside Alaska), but United States economists with experience in Latin America reported a high incidence of inefficiency due to bloated employment in public enterprises. Americanisation involved privatisation of public enterprises and widespread contracting-out of public services. (Australian governments had always relied on contractors for specialised services, particularly in construction, but this approach was extended to the planning and provision of a much wider range of public services.)

Second, the Arbitration arrangements, with their guaranteed role for trade unions, were un-American, for are not trade unions monopolists of labour? It was simple enough to abolish the Arbitration Commission, but politically more difficult to supersede its functions. Eventually the Commonwealth settled for a system in which it was rather difficult to organise strikes, but facilities remained for bargaining between employers and employees. Under full employment the unemployment rate had been kept to less than 2 per cent, but now rates of over 5 per cent were considered desirable to control inflation. The disciplinary effect of unemployment, mainly on relatively unskilled workers, was enhanced by increasing job precarity. This was not quite the full American medicine, but it came close.

By force of international circumstances and with considerable reluctance, Australia transited to a market-determined international exchange rate in 1983. The Commonwealth also abandoned most of its previous regulatory distinction between banks and non-banking financial intermediaries, a move which lifted the enforced conservatism of bank lending policies. The banks' initial reaction was to make ill-judged loans to 'entrepreneurial' businesses, which led to losses in the 1990 recession. They then discovered how neatly and profitably mortgage lending to households fitted into the macroeconomic policies of the early 21st Century and adjusted their marketing to emphasise mortgages. They have been highly profitable ever since. A final significant institutional change occurred in 1998 with the take-over by the Australian Prudential Regulation Authority of the Reserve Bank's previous powers to impose quantitative restrictions on lending by financial intermediaries. The Reserve Bank lost the power to squeeze credit, retaining only very limited power over short-term interest rates (with medium to long term rates determined on international markets in conjunction with the exchange rate). However, regulation did not entirely disappear, since the APRA was to ensure that, at the Authority's discretion, lending institutions retained sufficient liquid funds to cover possible future losses.

In all these reforms – tariffs, financial deregulation, privatisation, the demise of Arbitration – the influence of idealised competition was palpable. However, immigration reform took an altogether different path. Policy continued to encourage the immigration of people who, it was expected, would contribute to the growth of a significant nation, but the emphasis shifted radically from British to skilled and in the process began to accept significant migration from various Asian countries. Compared to the more strictly economic reforms, this reform gave the sense of a future in which Australia acts as a platform where the peoples of East, Southeast, South and West Asia can interact and maybe build an independent interpretation of Capitalism.

The limitations of competition

Even in the glory years of Competition, the limitations of economic theories which presumed widespread gentlemanly competition were noticeable. For example, Computable General Equilibrium models were found, by experiment, to be hopeless at predicting the short-term macroeconomic future, and Keynesian models were retained for this purpose. Practical economists also tempered their advice in other areas of analysis where technology, consumer behaviour and producer behaviour differed from neo-liberal assumptions. The role of technological development remained mysterious while economies of scale and agglomeration leading to oligopoly and oligopsony disrupted theoretical conclusions. So did the role of advertising. Did the claim that a competitive economy produced an optimum allocation of resources ring true when consumer demand was heavily influenced by marketing campaigns? And what about environmental and social costs?

There were further difficulties in defending the moral status of economic competition. Competition generates winners and losers, which is all very well in sport, where rules are observed and the consequences of winning or losing are limited. Not so in economic competition. Neo-liberal theorists may believe that they have specified the rules under which competition yields an optimum of a sort, but many of these rules are impossible to apply in practice and the rules which could be applied are enforced no more than sporadically. Even worse, optimum as a goal turns out to be far from inspiring, since it starts from the existing distribution wealth and limits itself to marginal changes which, in principle, make nobody worse off. Not even the richest. The rule is that, if one starts poor, one must continue poor. The only way up is to grab some little efficiency gain.

Despite these limitations, the glorification of competition has been a godsend to the more selfish of today's economic winners. It matters not at all that few, if any, of them can justify their winnings as a reward for their personal economic acuity and activity. They quietly overlook wealth acquired by inheritance, by corruption and by ignoring the rules of competition, preferring to assume that all winnings from economic activity are the rewards of socially-desirable competition. In other words, neo-liberal economics has pandered to their self-confidence and bolstered their sense of entitlement. Filled with self-confidence, these economic winners have been calling for tax cuts on their winnings. They have even argued that further heightening of returns will encourage more people to contribute to the common good by plunging into competition.

The general increase in economic inequality which resulted in the United States, Australia and other countries which implemented policies which glorified competition and cut taxes, resulted in a serious macroeconomic problem: a shortage of aggregate demand. We first take the Australian example.

First, the shift in income distribution towards the rich, especially such of them as squirrelled their billions away in tax havens, automatically cut consumption demand. An effective solution to this problem would be to increase taxes on high incomes and use the proceeds to assist low-income households, who are guaranteed to respond by increasing consumption demand. Admittedly, in the 1990s this was not such a sure-fire solution as it had been in the days when most of the goods and services bought by low-income households were made in Australia, but it would still have raised consumption demand. However, the necessary tax increases were unacceptable to the Tax Cut Lobby, and to make matters worse the winners from economic competition launched a media campaign to brand the losers as dole bludgers. The result was tax loopholes for winners and a redirection of the social security system to guarantee a modest standard of living for home-owning age pensioners while pushing the safety-net for people of workforce age well below the poverty line.

Second, the glorification of competition increased the riskiness of investment in business productive assets – buildings and productive equipment, further dampening aggregate demand. There was plenty of need for investment, most obviously to reduce environmental costs and curb greenhouse gas emissions. Australia's more sensible neo-liberal economists proposed a carbon tax, which would increase the price of greenhouse-gas intensive fuels and meats and so spur investment in alternatives, but this was torpedoed by the Tax Cut Lobby.

An alternative, with considerable precedent in Australian economic history, would have been resort to public enterprise to build replacement infrastructure. However, this would have been too abrupt a turnaround immediately after a welter of ideological privatisation and once again would have threatened tax increases unacceptable to the Tax Cut Lobby.

Accordingly, with the wholehearted cooperation of the banks, the Commonwealth relied on mortgage lending to top up aggregate demand – just old-fashioned mortgage lending, converted to computer administration but without the Americans' slicing and dicing. This maintained demand in construction, but turned out to have a serious downside. With suburban jobs disappearing due to the collapse of manufacturing, and city centre jobs increasing due to the rise of finance and the knowledge economy, an acute shortage of job-accessible urban residential land developed, resulting in skyrocketing land prices. This fundamental condition was then accentuated as the rising prices attracted speculators.

Unlike the United States Government and mindful of the need to maintain a reputation for financial rectitude to maintain its standing with its overseas creditors, the Commonwealth government did not borrow except in circumstances where its Keynesian model told it that demand should be stimulated. Thanks to this conservatism, the system survived the 2008 shock, but it remains fragile, with very high levels of both international and household debt, much of the collateral for which comprises urban land of uncertain long-run value. Apart from a few short-term rates, Australian interest rates are determined overseas, and an increase sufficient to cause a cascade of defaults is far from off the cards.

Faced with the same deficiency of aggregate demand and even more assertive demands for tax cuts, during the late 1990s the United States responded with a two-pronged program to increase demand. The Treasury borrowed from the public and from the world at large, and spent the money, and the finance sector beefed up its mortgage lending, allowing households to spend more than they earned, at least until a time of reckoning came. The United States financial sector was so innovative in its mortgage lending that that time of reckoning came in 2008. Since then, reliance has switched even more heavily to Treasury borrowing. This is the most likely source of the next big thump to the world economy.

Two other events should be remembered. During the land boom of 2000-08 it was noticed that Australia was borrowing overseas to finance residential construction. The close correspondence of this policy to that prevailing in Australia in the 1890s was noticed: residential development is far from guaranteed to generate export revenue from which overseas borrowing can be serviced. But then came the mining boom. The champions of competition assumed that high mineral export prices were permanent and took no action to ameliorate the effects of the resulting high exchange rate on non-mining import-competing industries, both rural and urban. The resulting loss of industrial complexity will be an incubus for the Australian for many years. Worse, the mining boom much strengthened the Tax Cut lobby, which is now led by people indistinguishable from the plutocrats who now rule the United Stated. They are not as dominant as in the United States, but their power puts them in a very threatening position.