

# The Budget Surplus Objective

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*An example of how economics is broken*

Discussion paper

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# Summary

The main aim of the Government's economic strategy seems to be achieving a budget surplus and so reducing government debt. Generally, a budget surplus produces an equal reduction in net government debt.<sup>1</sup> The purpose of this paper is to question the arguments put in favour of the strategy and point to some of the consequences of the surplus strategy.

Part of the appeal of surpluses is the picture of horror associated with their opposites—government deficits and the consequent debt. With regard to debt, and the fear it arouses, we point to both

- Australia's history when debt was much higher without apparent damage, and
- to other countries' experiences with much larger debt relative to the size of their economies and, again, little apparent adverse consequences.

Some of the supplementary arguments; flexibility to meet challenges, future debt burdens and the like are debunked. Some additional arguments for pursuing deficits instead of surpluses are put, including arguments suggesting that borrowings to finance infrastructure are often self-financing. We then point to the problems and other consequences of pursuing surpluses.

Government surpluses tax people more than necessary to finance the government's activities. Associated with that is a liquidity drain as cash in the banking system dries up. To compensate the government must purchase assets from the private sector in a way that does not compromise the surplus. Under the Howard/Costello Government it did that by buying back government bonds. But the present Government intends to inject liquidity into the system by not buying back government debt but buying other financial assets to reduce *net* debt. As we explore this issue more closely there are some interesting implications of the surplus. Effectively parts of the government sector are looking more and more like an investment bank with both large liabilities and large assets. Government bonds on issue will be 27.7 per cent of GDP in mid-2020 compared with net debt of 19.5 per cent of GDP. The difference is the value of financial assets financed by excess government borrowing.

The Treasurer sometimes cites the interest the government has to pay on government debt as a reason for running surpluses and reducing the debt. However, the Treasurer

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<sup>1</sup> The government usually publishes the market value of its debt so that changes in market values might also influence the value of outstanding government debt. Such effects tend to be minor.

modestly ignores the income the government receives through interest and dividends on its earning assets. As it happens, over the forward estimates interest and dividend earnings will be just short of interest payments.

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# Introduction

Former Vice President Dick Cheney “Reagan proved that deficits don’t matter” (Leung 2004).

In 2011 *The Australia Institute* published *Surplus Fetish* (Richardson 2011a) which argued that the goal of running budget surpluses was an irrelevant objective and distracted from the real issues facing society and the economy generally. We shall see that the present government has also committed heavily to attaining a surplus. However, in virtually adopting some of our arguments the Government has made it clear that the commitments to a budget surplus were on hold as a result of the bushfires in the summer of 2019-20. Governments seem to think more clearly about the budget balance when there are crises such as in wartime, when bushfires strike and with planning for the coronavirus. Nevertheless, the Treasurer said the bushfire funding could proceed without the Government reneging on a return to a budget surplus (Cranston 2020).

The purpose of this paper is to critically evaluate the Government’s obsession with generating a budget surplus and paying down government debt. The Government’s strategy sounds simple and certainly there are simple slogans that can be used to describe it. However, there are a number of questions arising from that strategy that we wish to raise. There are also a large number of ramifications of which the government is no doubt aware but which have received virtually no discussion in Australia.

The 2019-20 Budget announced that ‘the budget is returning to surplus in 2019-20’ and that ‘Sustained fiscal discipline will ensure these surpluses exceed 1 per cent of GDP in the medium term...Maintaining a strong economy and ongoing fiscal discipline is the best way of securing a more prosperous future for Australians’ (Australian Government 2019a, p 1-5). It should be pointed out that 1 per cent of GDP is \$19.7 billion using the latest 4 quarters of data (ABS 2019a) or approximately \$1,700 per taxpayer per year.

The federal budget presents a complex management puzzle that all governments have to address and explain to the electorate. Sometimes concepts are borrowed from the corporate sector and sometimes analogies are made with the household sector; the Howard Government, in particular, imported numerous corporate accounting concepts which remain in the budget papers. But often these concepts are applied uncritically and inappropriately. By way of discussing the budget balance, surpluses, deficits and the debt outcome, this paper touches on some of those inappropriate usages and their consequences.

Both sides of the political debate tend to pay homage to the virtues of a budget surplus along with the associated views that deficits and debt are ‘bad’ and need to be reined in as soon as possible. Indeed, often the rationale for surpluses is the need to pay down the debt. That was emphasised for example, with the mid December release of the Mid-year Financial and Economic Outlook (MYEFO). The Treasurer, Josh Frydenberg, said:

Well the Budget surplus has never been about a trophy for the cabinet shelf. What it’s been about is paying back the debt that we’ve inherited (Frydenberg 2019b).

Budget one-upmanship has moved beyond the balanced-budget obsession of the 1990s to the new aim of producing an ongoing surplus under which it is taken for granted that everyone will be better off. Accordingly, the main objective of the government is a surplus of one per cent of GDP. However, as has been mentioned and will be discussed below, the present commitment to a return to a surplus of at least one per cent of GDP can actually be seen as a commitment to tax the average taxpayer \$1,700 more than is necessary to match the value of government services.

The Rudd/Gillard Government was proud of its record during the global financial crisis when it allowed the budget to go into deficit, the automatic result of a downturn, and also deliberately increased the deficit through its stimulus packages. The aim was to prevent the economy from falling into recession so as to limit the increase in unemployment. Eminent economist Joseph Stiglitz praised Australia’s stimulus package saying: ‘my impression was that it was the best—one of the best-designed of all the advanced industrial countries’ (ABC 2010). Stiglitz also pointed out that countries faced with recession have a choice: they can waste money on government spending or they can waste human beings in unemployment and business failures. Without the stimulus, and assuming the earlier unemployment forecasts had been borne out, Australia would have lost production of around \$44 billion per annum, which in turn would have had an ongoing impact on government revenues.<sup>2</sup>

The notion that a surplus is always preferable has been accepted uncritically for too long. Many economic commentators seem to want to wage war on the deficit: they might be called ‘deficit hawks’. There are, however, awkward questions the deficit hawks should answer. Ironically, as will be discussed below, the financial markets actually need quite a large supply of Australian Government securities; the last thing ‘the markets’ want is the complete drying up of public sector debt. At times, they have lobbied for more. Indeed, government bonds can often be a safe harbour for asset holders in times of financial uncertainty.

Before continuing, a common misunderstanding needs to be clarified—government surpluses, debt and deficits have nothing to do with *Australia’s foreign debt*. Government

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<sup>2</sup> This is based on the 2009 budget estimate of unemployment at 8.5 per cent for 2010–11 (Australian Government 2009) compared with the outcome (five per cent, ABS 2019d) and assuming employment and GDP change in the same proportions.



debt is the outstanding value of government borrowing while foreign debt refers to all debt in Australia held by foreign residents and entities. But apparently there is potential for confusion. On 9 February 2010, the then Opposition's shadow finance minister, Senator Barnaby Joyce, said on the ABC TV:

We're going into hock to our eyeballs to people overseas. And you've got to ask the question how far in debt do you want to go? We are getting to a point where we can't repay it (ABC 2010a).

Barnaby Joyce appeared to be confusing government debt with Australia's foreign debt. Australia's foreign debt is large and it is a concern,<sup>3</sup> but almost all of it is a result of borrowings on the part of the private sector, including some heavy borrowing by the four big Australian banks. Private foreign debt is beyond the scope of this paper; rather, the purpose here is to question the notions of the 'fiscal hawks' as they are referred to in the US—the notions that government surpluses are 'good' while debt and deficits are 'bad'.<sup>4</sup>

It must be pointed out that things have changed dramatically with the Government's response to the bushfires. According to *The Guardian*, Prime Minister Scott Morrison said the government was not focused on the financial cost and said:

The surplus is of no focus for me, what matters to me is the human cost and meeting whatever costs we need to meet. I can tell you this: being in the position of strength we are in now enables us to give what is one of the most significant, if not most significant, response to a crisis of this kind the country has seen (Martin 2020).

Dr Lowe also made the point that 'Whether or not the government has a small budget surplus from an economic perspective is not really that important' (Wright and Wade 2020).

## CROWDING OUT

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If we had any doubts about orthodox economics and economic management, the 2008 global financial crisis and its aftermath should have completely shattered our confidence. According to *The Economist* (16 May 2019) 'the argument that debt is crowding out private investment is hard to sustain when firms are awash with cash and can borrow at extremely low rates'. Let us make clear at this point that reducing government debt is taken to be equivalent to achieving surpluses. The discussions mostly focus on net debt and so the two

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<sup>3</sup> At the time Australia's net foreign debt was \$166 billion or 54 per cent of GDP (ABS 2019b).

<sup>4</sup> The possibility that the government can borrow externally is not considered in this paper for two reasons. First, when Paul Keating was Treasurer, the government stopped its overseas borrowing program (Martin 2007), the overseas debt was paid out as it retired and there are now only nominal amounts remaining (See Australian Office of Financial Management 2010). Second, while some net debt denominated in Australian dollars is held by foreigner interests, it is actually domiciled in Australia, suggesting that foreign companies are using it as part of their Australian operations. See ABS (2019b).

would be exactly expressed by saying that a budget surplus is equivalent to the net reduction in government debt. We might also add a qualification relating to market valuation effects but those have tended to be minor and will be ignored in this paper.

In the US, like in Australia, debt is emphasised by those who want to score political points. Hence as one US observer puts it:

Depending on which political football is being tossed around, this “national debt” is either a crisis that must be addressed first (before anything else can be paid for!) or it’s something we can simply ignore for the time being—until the promised “economic growth” comes along...

The mystery is, while all this perpetual haggling and hand-wringing is happening, no one seems to be knocking on America’s door asking to be repaid. Unlike Greece and Italy who are constantly being squeezed by the E.U. central bank and the IMF to repay their debts, no one seems to be squeezing the U.S. at all. Unlike Spain, which gets an earful from Germany if it even whispers about increasing its national borrowing, the U.S. hears nothing from anybody (except its own politicians and pundits) when it votes to raise the beanstalk one cap higher. How can that be? It’s almost as if—weirdly—there isn’t anyone out there expecting to get paid back (Alt 2018).

Of course, US bond holders do expect to be paid back, it’s just that they are not concerned about the size of the debt – they understand the US Government will always be able to refinance in its own dollars (unlike, say, Greece, or Nevada). In the public debates some politicians can point to the national debt as why:

it’s impossible to even discuss the need to spend new dollars to address any of the dire and critical things America confronts as a collective society. We can’t repair our dangerously impaired highway bridges. We can’t modernize our air-traffic control system. We can’t replace our failing, lead-polluted, water-systems ... (Alt 2018).

This list is extended to include many more items but the point is clear.

Forbes has commented that ‘There is a growing body of literature showing that austerity policies can be unnecessary even when a government is highly indebted’ (Coppola 2018). Forbes points to arguments like those in this paper. It also adds that deficit hawks like to point to examples like Greece which got into trouble with an unsustainable debt. But the answer is that Greece no longer has an independent monetary policy having ditched the Drachma and adopted the Euro. Greece in the Euro system is now analogous to the city of

Detroit which went into bankruptcy,<sup>5</sup> something that cannot happen to the US Federal Government which operates an independent monetary system.<sup>6</sup>

*The Economist* reflected on government debt and said, ‘government borrowing looks less scary than it used to, and some mainstream economists are reconsidering the profession’s aversion to debt’ (Economist 2019). The Economist continued:

They [economists] once feared “crowding out”—that government bonds would lure capital that would otherwise finance more productive private-sector projects. But real interest rates around the world have been falling for most of the past 40 years, suggesting that there are too few potential investments competing for available savings, rather than too many. Indeed, government borrowing could “crowd in” new private investment. Public spending on infrastructure might raise the returns to private investment, generating more of it (Economist 2019).

*The Economist’s* present position of course contrasts dramatically with the language of the Coalition, both in Opposition prior to 2013 (See Richardson 2011a,b) and in Government since then, albeit with more moderate rhetoric in Government. More generally economists’ language tends to be moderate and focuses on possible crowding out. By contrast politicians and some other commentators bring in such red herrings as ‘living beyond our means’ and ‘burdens on future generations’. We will dispel those myths below.

Given the hysteria that accompanies discussions about debt it must be amusing to many people to learn that the only adverse consequence of government deficits serious economists can identify is the crowding out of other spending. Obviously if true that would be serious but the idea of ‘living beyond our means’ was supposed to convey impressions of impending debtors’ prisons or other evils. In fact no-one seems to have been hurt by a government bond either in Australia or elsewhere in the world.

*The Economist* did point out ‘that still leaves bills to be paid’. Even if governments do want to pay down their debt a former IMF chief economist, Olivier Blanchard, pointed ‘that when the pace of economic growth exceeds the rate of interest on a country’s debt, managing indebtedness becomes substantially easier. In such cases debt incurred in the past shrinks steadily as a share of GDP without any new taxes needing to be levied’ (*The Economist* 2019). That is basically what happened in Australia immediately after World War Two when

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<sup>5</sup> Details can be found in the Wikipedia entry.

<sup>6</sup> Strictly speaking there were 31 sovereign governments that defaulted between 1960 and 2017 as identified by researchers from the Banks of England and Canada (Beers et al 2019). However, these ‘defaults’ involved cases such as compulsory currency conversions at unfavourable rates, new taxes on government bond interest, and similar policies. These tended to reflect policies far removed from responses to the financial crises we have in mind here. Arguably these should not be thought of as defaults at all.

the debt to GDP ratio was over 100 per cent but declined to a third of that within a couple of decades.<sup>7</sup> The Blanchard argument will be outlined below.

Given the low-key approach to government debt in recent years it is important to ask why the Government has again chosen to make it a focus of its policy. Reducing debt in a low interest environment must be one of the least important priorities; especially when ranked against poverty, inequality, inadequate health, education and other services, deteriorating infrastructure and so on.

## THE US EXAMPLE

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CBO data (CBO 2019) suggest net US debt was 78 per cent of GDP in 2018 and is expected to reach 95 per cent in 2029. Net figures are lower at 69 per cent in 2018 and are expected to reach 88 per cent in 2029. If Australia has a problem then the US should be so much worse. But that is not the US experience. Accordingly a recent Wall Street Journal article suggested ‘U.S. deficits may not matter so much after all—and it might not hurt to expand them for the right reasons’ (Harrison and Davidson 2019). According to The Economist (16 May 2019) ‘warnings [such as the CBO projections] have fallen on deaf ears not just in Washington, but on Wall Street too. Financial markets, hungry for dollar-denominated safe assets [i.e. Federal Government bonds], betray no concern about America’s debts’ (The Economist 2019).

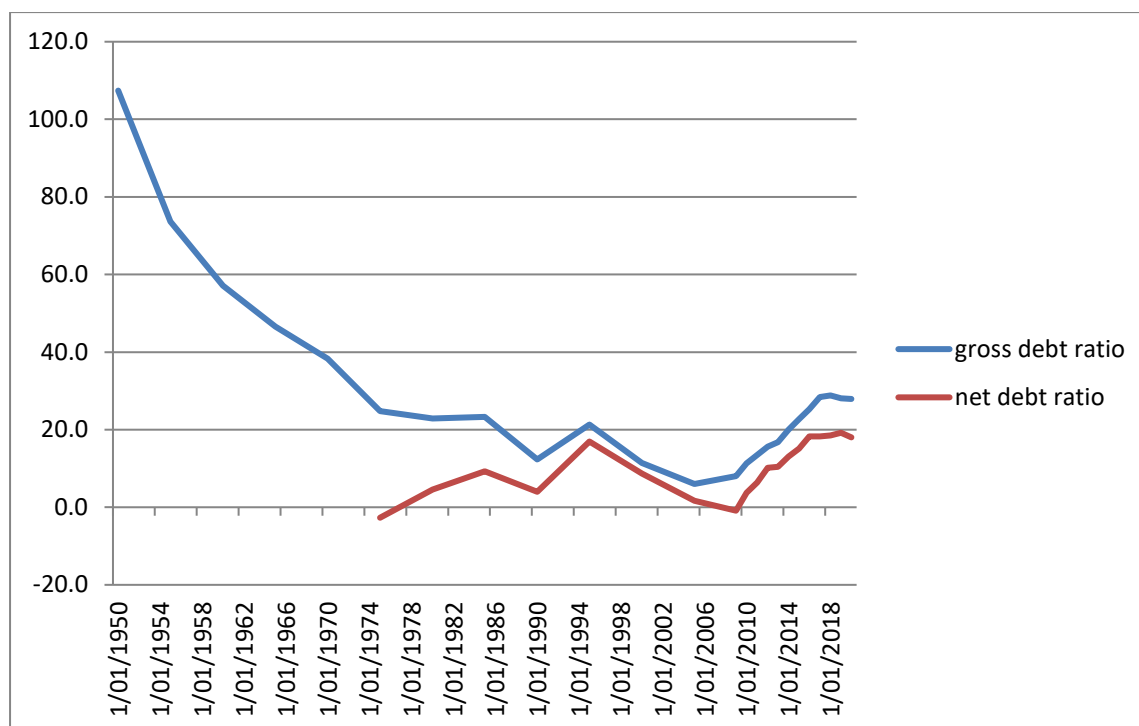
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<sup>7</sup> See Richardson (2011b) which added that ‘it’s hard to find any evidence that the people in the post war decades were worse off as a result of the level of public debt’.

# Historical and international debt comparisons

When Australia's current level of debt is compared with past levels, or considered in the international context, it is difficult to see why prevailing debt and deficits are of so much current political interest. On current forecasts, Commonwealth debt will be \$392 billion in mid-2020, which, while seemingly large in absolute terms, is only 19.5 per cent of GDP (Australian Government 2019a). This can be compared, for example, with the level of Commonwealth debt on the eve of Australia's post-war golden age; in 1950, government debt was 107 per cent of GDP (Reserve Bank of Australia, 1997), approximately \$2,080 billion if expressed in today's dollars. Figure 1 graphs Australia's gross government debt to income ratio from 1950 to 2020 together with net debt figures from 1975 onwards. Note that earlier figures for the Commonwealth gross debt include some borrowings on behalf of the States and Territories.

**Figure 1: Gross and net debt to GDP ratios (%)**



Source: Reserve Bank of Australia (1997); ABS (2019a,c) and (Australian Government 2019a).

As can be appreciated from Figure 1, Australia's gross debt to GDP ratio is just above its post-war low. Net debt<sup>8</sup> figures are not available for the whole post-war period and the gross figures will overstate the net position somewhat.<sup>9</sup> Nevertheless, the gross figures are interesting as they reveal that Australia's debt has fallen substantially over the course of the post-war period. In net terms, Commonwealth debt actually disappeared in 2005–06 and then reappeared in 2009–10 with the global financial crisis. By any criterion, Australia's debt is now at an historic low.

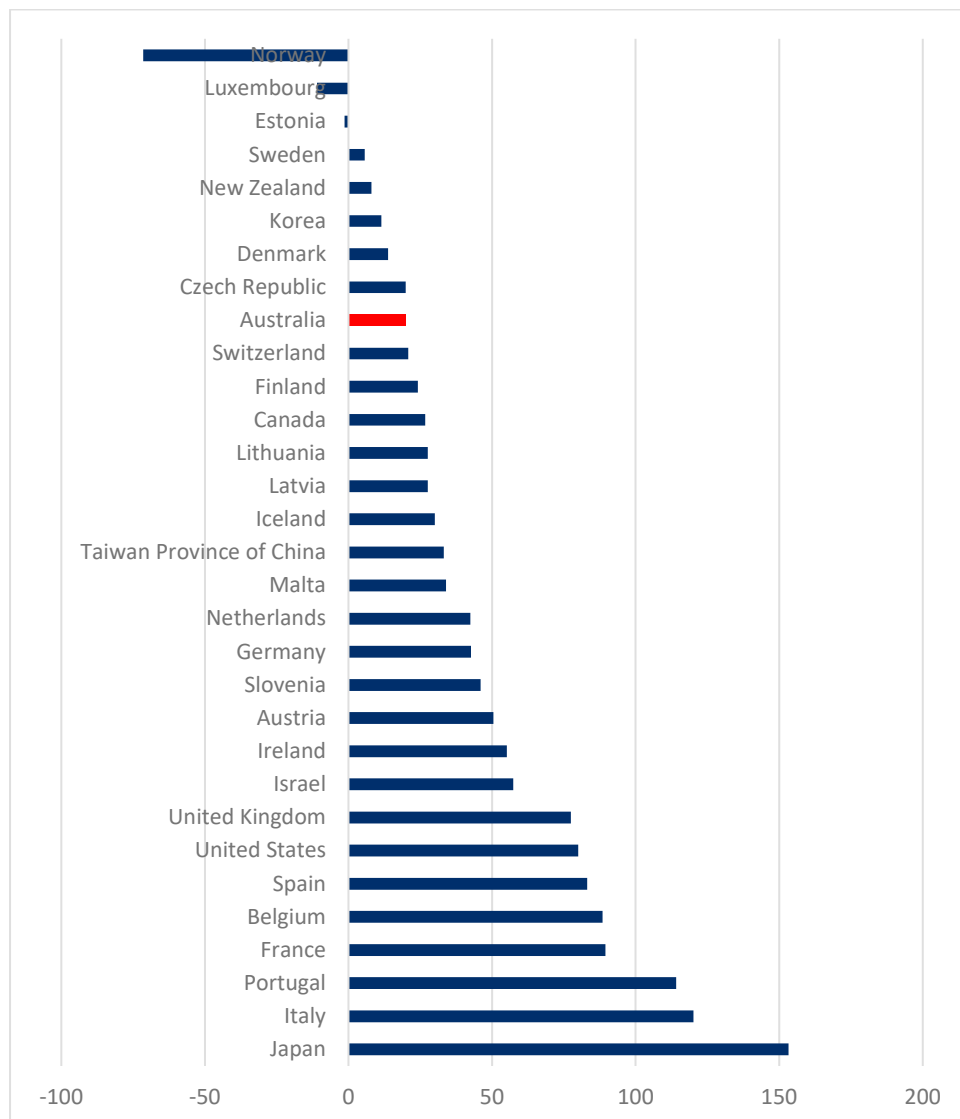
The Australian Government's debt is also very low compared with other developed economies. Figure 2 shows Australia's recent net government debt and compares it with the debt in other major countries, expressed as a ratio of debt to GDP using IMF data expressed in calendar years. Australia's ratio is shown in red.

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<sup>8</sup> Net Commonwealth debt is gross debt less financial assets held by the Commonwealth.

<sup>9</sup> Gross debt refers to all the debt on issue by the government while net debt deducts from that any financial assets held by the government.

**Figure 2: Advanced economies, debt ratios (%)**



Source: International Monetary Fund (2019).

Figure 2 makes it immediately apparent that Australian debt is well below the levels currently experienced in other economies where debt ratios tend to be 50 per cent or more, well above the Australian rate. Indeed, Australia's debt at 20 per cent is much lower than most economies included in Figure 2.

Before leaving this section, it is important to point out that movements in net debt reflect more than just the budget balance. Governments can artificially lower net debt by selling physical assets.<sup>10</sup> The Howard Government, for example, reduced debt by \$45 billion as a

<sup>10</sup> Under the accounting rules that apply to the Commonwealth budget, sales of financial assets are treated as 'below the line' items that change the composition of the net debt but not its magnitude. However, the purchase of actual goods and services as well as transfer payments are transactions that involve a flow of

result of the sale of Telstra and other major government assets,<sup>11</sup> the equivalent of a household selling the home to pay off the mortgage. The government's net worth did not change, but the government was able to claim that it had reduced debt.

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resources between the public and private sectors and so are included as ordinary spending in the budget papers.

<sup>11</sup> A list of asset sales going back to 1988 is maintained by the Department of Finance (2019).



# Surplus thinking and private analogies

Surplus thinking, primarily the confusion between private profit and a government surplus, is a symptom of private-sector principles being applied inappropriately to the public sector. The owners of a private business clearly hope it runs at a profit so that it can both survive and pay a dividend to its owners. The payment of a dividend by a private company is a distribution of profit to the company's shareholders and is not counted as a cost to the business. That is, the objective of a private firm is to generate more revenue from selling a product than the costs incurred in making that product so that profit can be generated and then distributed to the owners of the company. The objective of a government, however, is to raise resources from the community in order to fund public activities, transfer payments or investments. The pursuit of a budget surplus is therefore the pursuit of excessive tax collections relative to the desired level of public spending.<sup>12</sup>

Table 1 shows some of the conceptual differences between commercial and public sector accounting. The public sector accounts illustrated here are based on the cash accounting figures in the budget papers.<sup>13</sup>

**Table 1: Differences between corporate and public sector accounts**

	Corporate	Public sector (cash accounts)
Level 1	Income, mainly sales revenue	Revenue, mainly tax receipts
Level 2	Costs, including operating costs, financing costs, asset revaluations etc	Outlays; current plus capital investments
Level 3	Profit (= level 1 minus level 2 minus tax)	Surplus (= level 1 minus level 2)
Level 4	Dividend payments and/or change in net financial assets (retained earnings), tax.	Change in net financial assets

Note: Investment is not included in the company's operating statement.<sup>14</sup>

<sup>12</sup> That should not be taken as endorsing a balanced budget strategy as will become clearer below.

<sup>13</sup> The Treasurer and most commentators use the cash figures. However, the budget papers also include accounts based on accrual concepts that attempt to emulate the private sector to some extent. See Australian Government (2019a) especially Statement 3.

<sup>14</sup> Capital investments themselves are not included in the private sector's operating statements because long-life assets such as plant and equipment will contribute to the firm's operations over many years. Instead, the private sector can include 'depreciation' of the capital stock in its operating statement. 'Depreciation' in a particular year can be thought of as a rough measure of how much the capital stock has 'worn out' in that year's operations. (Instead of actually measuring the latter, depreciation tends to be computed using arbitrary accounting rules and conventions.).

Both sectors have funds coming in at the top level: the main source of funds for the corporation consists of its sales revenue while the main source of revenue for the public sector consists of taxation receipts. At level 2, the company incurs costs when it pays for labour, materials and a wide range of other items necessary to produce its output. If it is successful in keeping its costs lower than its revenue, it will generate a profit shown at level 3. At level 2, outlays for the public sector include such things as pensions and defence through to flood relief and, significantly, all capital investments—new buildings and computer systems for example. If the public sector spends less than its revenue, it results in a surplus.

Table 1 traces what happens to the corporate profit and the public surplus. In the case of corporate profits, some is likely to be paid to the government in tax, some may be retained in the business as ‘retained earnings’,<sup>15</sup> and some is likely to be paid to the owners of the corporation as dividends. Public sector surpluses, however, can be used either to acquire financial assets or to repay debt.

This does of course raise the question as to whether the government should be making a ‘profit’ from raising taxes in order to pay the age pension. And if not that then on what activities should the government be making a profit?

To some extent, the public and private concepts of income and expense are analogous to each other; however, there are potential errors if those analogies are pushed too far. For example, private expenses are a necessary input to production and a good manager will endeavour to keep them as low as possible. However, government outlays include such items as the age pension, which is really a means of redistributing and sharing the income generated in Australia, as is the purchase of tanks, guns, aircraft and ships where the aim is to maximise Australia’s defence preparedness. Paying lower wages might be seen as good by an employer but paying lower pensions to pensioners is not good for the country.

While income and expense in the public and private sectors have something in common, private profit and public sector surpluses are fundamentally different. Profits are not analogous to a public-sector surplus and the concept of profit and dividend distribution cannot apply to the government. The notion of a profit is meaningless from the point of view of public accounts. Any attempt by a government to pay a ‘dividend’ by giving money back to its owners (the people) eliminates the surplus. That is, when governments return money to its owners, it is either by way of a tax cut or a payment such as a social security

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<sup>15</sup> ‘Retained earnings’ are after-tax profits that are not distributed to the owners. Companies tend not to distribute all their profits to their owners, retaining some of the money for various reasons such as expanding the business through new investments. Although the owners do not have the cash in their hands, they will benefit because the increase in company assets is likely to increase the value of the organisation.

benefit, two items that both reduce the surplus.<sup>16</sup> This example again illustrates how private sector concepts are inappropriate in the public sector.

The impossibility of returning a budget surplus to the community without simultaneously reducing that surplus highlights the fundamental illogicality of using the private sector analogy of profit to evaluate the desirability, or otherwise, of a surplus. Furthermore, it leads to the logical slip that suggests surpluses can be accumulated for use at a later date. This is discussed further below.

The notion that because a private profit is 'good', a public surplus must also be good seems to have found its way into the budget papers and reflects the view that a government surplus is a valuable target of public policy. For example, despite the success of the stimulus package, the 2019-20 budget papers announced that the government is determined to return to surplus.

Thus, the MYEFO reaffirms that the government intends to maintain a tight limit on spending to fit in a surplus under the self-imposed tax limit of 23.9 per cent of GDP. These restraints seem designed to conceal the choices available to voters in apparently objective statements of what is feasible. Rather than offering society a choice between increased social welfare and other spending initiatives or fiscal 'discipline', the apparently objective targets seem to have been designed as some sort of quasi-scientific canon to rule out-of-bounds otherwise worthwhile objectives and conceal the available alternatives. If these rules are going to impose limits on what governments can do, there should be some solid argument behind them but that is not really the case at all. An obsession with surpluses is dangerous but, when combined with arbitrary rules about the level of tax governments can collect, the result is an undemocratic attempt to conceal choices from voters.

## DEALING WITH FUTURE CHALLENGES?

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The 2019-20 budget claims that '[t]hese surpluses will pay down debt to ensure that Australia is better equipped to deal with future challenges' (Australian Government 2019a, p 1-5). It goes on to say that '[a]s the budget returns to surplus, the Government will focus on strengthening the balance sheet through public debt reduction to ensure the longer-term sustainability of the budget. Paying down public debt ensures that the Government is better equipped to deal with future challenges' (Australian Government 2019a, p 3-1). This particular quote is repeated in the budget papers. The government goes on to say '[m]aintaining debt at prudent levels is an important element of improving the strength and sustainability of the Government's financial position. It provides the Government with flexibility to respond to changing economic conditions and also ensures that future

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<sup>16</sup> It could be returned in kind through additional spending on education and health, but that would also eliminate the surplus.

generations are not burdened by excessive debt from past government spending' (Australian Government 2019a, p 3-7). The generational issues will be discussed below. Here we focus on the 'flexibility to respond to changing economic conditions'.

Note first that the surplus strategy is tied up with additional aspects of an austerity program such as:

- strong fiscal discipline by controlling expenditure to reduce the Government's share of the economy over time
- stabilising and then reducing net debt over time
- maintaining a sustainable tax burden consistent with the economic growth objective, including through maintaining the tax-to-GDP ratio at or below 23.9 per cent of GDP, and
- the budget repair strategy is designed to deliver sustainable budget surpluses building to at least 1 per cent of GDP as soon as possible (Australian Government 2019a, 3-8).

Of course, not all of these elements are independent and, for example, reducing net debt is the logical implication of a surplus.

The aim of maintaining the tax to GDP ratio at any given figure is of course arbitrary and could be setting the government up for failure. We have argued strongly against such policy elsewhere (Richardson and Browne 2018). Apart from sentiments such as reducing debt to sustainable levels there is no logic or theory underpinning the need for surpluses. We can only assume the thinking here is that if we don't borrow now we might be able to later when we may really need to borrow, perhaps to finance deficit spending (?). The only elaboration in the 2019 budget papers says '[a] strong balance sheet provides the Government with flexibility to respond to unanticipated events, such as financial crises or economic shocks' (3-14). It is interesting to note that prior to the 2000-01 Budget the Commonwealth had never published its balance sheet and there were no concerns as to whether or not it was 'strong'. It seems to be a case of concentrating on what we can measure. More importantly there are unquantifiable items that cannot go into the balance sheet such as the unlimited capacity to tax transactions in Australia together with the unlimited ability to issue legal tender. It is these items that destroy any analogy with balance sheets in the private sector.

Suppose Australia was hit by a serious pandemic that involved a massive intervention as large numbers were dying and there was the need to keep masses of people in care and quarantine for many suspected cases. In such a scenario the government would need to mobilise medical staff, organise quarantine facilities, hospital beds and buildings, transport restrictions and management and so on. All the money on deposit with the Reserve Bank and all its financial assets would be of little use. The absolutely critical thing is that the physical resources are in place and managed appropriately. If that happens then the

government simply pays its bills no matter what the budget history has been. The government does not need to go to the market and borrow first and no-one is going to reject their payslip because the budget is not balanced. But if the physical resources are not in place then there will be even worse outcomes whether or not government has reduced government debt.

## INTERGENERATIONAL EQUITY?

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As mentioned earlier, the budget papers also refer to intergenerational equity as a reason for running surpluses and paying down debt. For example, the 2019-20 budget papers say that '[w]ith the budget returning to surplus, the Government is strengthening its focus on paying down debt *to reduce the fiscal burden on future generations*' (Australian Government 2019a, p 1-1, emphasis added). The clause in italics is emphasised because it is repeated many times in the budget papers.

The message appears to be that borrowing imposes a burden on future generations and if it is avoided people in the future will be better off. Malcolm Turnbull, when Opposition Leader, said much the same:

For at least 60 years, it has been a proud boast that every generation of Australians has left its children better off than their parents. As Rudd Labor's debt piles up unrelentingly on the shoulders of taxpayers of the future, we have to ask the tough questions: will we be the first generation not to deliver on that dream? Will we, through reckless and irresponsible decisions, deny the next generation their fair share of opportunities in life? (Turnbull 2009).

The notion that Government borrowing today imposes a 'burden' on future generations needs to be examined, especially in view of the fact that debt was 107 per cent of GDP in 1950 and the Australian economy did not seem to suffer in subsequent years. Upon closer examination, the notion breaks down and it is easy to see why. Suppose there were a large amount of government debt on issue at this time, perhaps \$1000 billion paying a yield of five per cent, costing the government \$50 billion per annum in interest. Suppose that there is a balanced budget so that taxes are higher by \$50 billion to finance the government's interest bill.

People such as Malcolm Turnbull seem to refer to the \$50 billion additional tax as the 'burden' in question, but that tax goes to make interest payments to other Australians. If the additional tax is a burden, the additional interest payments of \$50 billion must logically be the opposite of a burden. The payment of \$50 billion by some members of the economy is matched by an income of \$50 billion to other members of the economy. In fact, if everyone held equal amounts of government debt and paid equal taxes there would be no

change in anyone's income.<sup>17</sup> Similarly, there would be no change in total net income in Australia. Of course, people do not pay equal amounts of taxes and do not hold equal amounts of government debt—rather, the holders of government debt are likely to be concentrated among higher-income earners, as are those with high tax liabilities.<sup>18</sup> Hence, it is incorrect to reason that a future cohort of people is somehow burdened by the actions of a previous generation when the net income of the future generation will be unchanged. Indeed, some of that future cohort may well be better off simply due to the fact that their parents have been saved from a prolonged period of unemployment and poverty. In addition, assets funded by government debt, like the Sydney Harbour Bridge, have made everyone better off.

From an intergenerational perspective, the one bequest an earlier generation can genuinely make to a future generation consists of the physical assets of the nation, including everything from the local town hall building to the environmental quality of Australia's river systems. There are, of course, a host of issues relating to the preservation of physical assets in Australia but those are beyond the scope of this paper. But the important thing is that as we limit the spending on infrastructure and other items we thereby reduce the inheritance of the future generations.

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<sup>17</sup> Depending on the actual pattern of interest payments and taxation there will be a redistribution of income from rich to poor or *vice versa*, which may warrant government action. However, that does not seem to be what people like Turnbull have in mind.

<sup>18</sup> Some of the debt will also be held by corporations and some of the tax will also be paid by corporations and other bodies, but these are ultimately owned by individuals. Interest on debt held by foreign residents may attract interest withholding tax.

# Active fiscal policy—the alternative view

The view of this paper is that governments can and should use fiscal policy to help deliver a desirable set of macroeconomic and social outcomes achieved by setting the spending and taxing tasks to fit the needs of the economy. This is exactly what Australian governments did in response to the 2000–01 downturn and the global financial crisis beginning in 2008. These events suggest that the appropriate thrust of fiscal policy should be consistent with Australia’s macroeconomic targets. The outcome in terms of the budget balance—be it surplus or deficit—should be whatever is required to fit in with spending and taxing tasks. Until recently, most economists accepted the need for an active fiscal policy in framing budgets.<sup>19</sup>

Briefly, the active fiscal policy hypothesis calls for a budget balance that is whatever is needed to achieve full employment without inflation. If the economy enters a downturn, the active fiscal policy view holds that there is a need for government stimulus, which normally results in a budget deficit. On the other hand, if the economy is heading for a boom, contractionary, anti-inflationary measures are called for whereby spending is reined in and/or taxes increased, which may result in a surplus. John Maynard Keynes is famously associated with advocacy for public spending on job-creation works to overcome the effects of a slump. However, less well-known are his views on using contractionary measures to control excessive demand, which are outlined in his book, *How to pay for the war* (Keynes 1940). The important point is that whether the government produces a surplus or deficit should reflect the objective needs of the economy.

In a sense, the case for an active fiscal policy is an argument that fiscal policy should be managed in a similar way to monetary policy. There are no fixed rules associated with the management of monetary policy; instead, the RBA board meets once every month (except January) to decide whether the present monetary policy settings are appropriate. The objectives of the RBA are set out in Section 10(2) of the *Reserve Bank Act 1959* and include:

- the stability of the currency of Australia
- the maintenance of full employment in Australia
- the economic prosperity and welfare of the people of Australia.

As circumstances change, the RBA must assess the needs of the economy, keeping in mind its own requirement to aim for a combination of low inflation and low unemployment;

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<sup>19</sup> Previously this was known as the functional finance view of government budgets and was initially associated with early post-war Keynesian economists of whom Abba Lerner (1951) was the most prominent.

according to its judgement, it adjusts monetary policy to be either more stimulatory or more contractionary.

Among Keynesian economists, the only reason for concern about the budget balance was to ensure the settings were just right to achieve the desired macroeconomic outcomes for the economy. Indeed, there can be no more important role for fiscal policy—the achievement of macroeconomic balance without excessive unemployment or inflation. The active fiscal policy literature sees no particular merit in any particular budget outcome; the overriding consideration should be exactly what the needs of the economy warrant in terms of macroeconomic management.

Ironically, one of the best defences of deficit spending in recent years was contained in the Howard/Costello Budget of 2001–02, a time when weakness in the economy justified a stimulus through government spending. As the budget papers explained:

The Government has provided a moderate stimulus in the 2001–02 Budget through targeted tax reductions, discretionary spending and by allowing the Budget to respond to the temporary slowdown in economic growth (through the operation of the 'automatic stabilisers' which reduce tax revenues and increase expenditure). This is an appropriate policy response to recent economic developments (Australian Government 2001).<sup>20</sup>

This passage is putting the active fiscal policy view that the slowdown in economic growth warranted stimulatory spending. Of course, the immediate impact of the tax reductions and spending increases was to push the budget further into deficit. The statements of the Rudd Government at the time of the global financial crisis also endorsed active fiscal policy.

Australia was not the only country to introduce a stimulus package; such packages were introduced in countries as diverse as the US and China and were endorsed by the International Monetary Fund and the OECD. More than a decade on and the Australian economy is weak and the RBA has effectively conceded there is little it can do to restore healthy economic performance, a job for fiscal policy (Stanford 2018). The present is the wrong time to be aiming for a budget surplus.

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<sup>20</sup> The 'automatic stabilisers' refer to the natural tendency of the deficit to increase during an economic downturn as a result of two factors:

- First, the tendency for tax collections to fall as there is less taxable income earned in the economy during a downturn.
- Second, the tendency for government spending to increase in a downturn as more people claim government benefits, especially unemployment benefits.



## HOWARD AND COSTELLO ON THE SURPLUS

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Immediately after delivering the 2000-01 Budget, then Treasurer Peter Costello, was pressed on why the Government did not try for a bigger surplus, to which he said all you can do with surpluses is repay debt and the Australian Government has done that (ABC 2000a). The then-Treasurer said nothing that would indicate any intrinsic merits of running surpluses. The Prime Minister, John Howard, put a similar view the following morning on the ABC program AM when he said 'running up big surpluses for their own sake is not good economics. There's no law of good economics that says you should have ever increasing surpluses' (ABC 2000b). Of course, in the light of the above arguments we would not agree that even reducing government debt is a worthwhile objective. Whether or not the government runs a surplus or deficit should depend on the important economic issues facing the country at the time.

## WHAT THE AUSTRALIAN CORPORATE SECTOR THINKS

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As this is being written the Australian economy is going through a slump and the latest national accounts figures for the September quarter (ABS 2019a) showed private spending contracted by 0.1 per cent or by 0.3 per cent for the four quarters to September 2019. What growth there was in Australia was due to government spending, especially in health and the National Disability Support Scheme.

It has been reported that Australia's top corporate executives say the government must stimulate the economy through fiscal policy and said:

respondents to The Australian Financial Review's annual Chanticleer CEO survey believe more must be done to lift business confidence, including the introduction of a business investment allowance (Thomson and Boyd 2019).

At least one CEO, Bendigo and Adelaide Bank's Marnie Baker, said 'the government's focus on returning the budget to surplus was hurting economic growth' and that 'The government has an economic lever readily available to them – greater public spending and infrastructure development' (Thomson and Boyd 2019).

Despite such calls from many quarters the Financial Review reports:

The Morrison government shows little willingness to embark on a fiscal stimulus that would undermine its budget surplus pledge. Frydenberg says he is determined to "stay the course" on the budget plan (Kehoe 2019).

The opportunities of many jobseekers were being sacrificed so the government could avoid losing face.

We acknowledge that many people do have concerns about the level of government debt and so support a surplus as a means of eliminating the debt. However, the fear of government debt is vastly overblown as we show in the next section.

## THE BLANCHARD THESIS AND OTHER ARGUMENTS

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Olivier Blanchard<sup>21</sup> has recently put the argument that increasing government spending for most economies is costless. As Blanchard puts the argument:

the current US situation, in which safe interest rates are expected to remain below growth rates for a long time, is more the historical norm than the exception. If the future is like the past, this implies that debt rollovers, that is the issuance of debt without a later increase in taxes, may well be feasible. Put bluntly, public debt may have no fiscal cost (Blanchard 2019).

The argument relies on the empirical observation that in most countries for most of the time the rate of economic growth is greater than the interest rate. In that case a government that borrows to finance the initial spending as well as the subsequent interest bill will nevertheless see that debt fall as a share of GDP. Suppose Australia has a GDP of \$2 trillion and borrows \$560 billion.<sup>22</sup> Economic growth is around 4.5 per cent (2019-20 Budget paper no 1) and assume interest rates at 2 per cent (well above the present rates on 10-year bonds quoted in the financial press during December 2019). In this case the debt to GDP ratio starts at 28 per cent of GDP but within 10 years is down to 22 per cent. In 20 years' time the figure falls to 17 per cent.

Lawrence Summers (2014) goes further and, quoting IMF figures, suggests public investment is essentially costless – the classic free lunch. The IMF estimates each dollar of spending increases output by nearly \$3, which of course implies higher taxes very soon and well into the future. Summers says:

What is crucial everywhere is the recognition that in a time of economic shortfall and inadequate public investment, there is for once a free lunch – a way for governments to strengthen both the economy and their own financial positions. The IMF, a bastion of “tough love” austerity, has come to this important realisation. Countries with the wisdom to follow its lead will benefit (Summers 2014).

Comments by one Australian banker put the clear view that with interest rates currently so low the government should in fact borrow to invest. Cameron Clyne, the former CEO of the National Australia Bank, put the view that the government should be borrowing more and

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<sup>21</sup> Oliver Blanchard is a Senior Fellow at the Peterson Institute for International Economics and prior to that was chief economist at the IMF.

<sup>22</sup> That is roughly the size of Australia's present GDP and gross government securities on issue.

exploiting its good credit rating and access to cheap capital. In his view government can finance long-term roads, rail and ports 'far more effectively'. He also said 'we [meaning Australia] don't have enough [debt]. We have a lazy balance sheet...We have a unique window as a AAA nation with strong demand for AAA debt to issue that debt and divert it to productive infrastructure' (Bennet 2013). Clyde Cameron was clearly thinking in terms of how a commercial organisation might address the issue and, in that framework, the government was being too austere.

Mr Clyne was absolutely right and has been supported by the RBA in more recent times. As already argued above, the government has been able to borrow at well below two per cent. Periods of low interest rates are the perfect time for investing in capital intensive projects. The hurdle rates of return that projects need to generate is so much lower and the borrowing costs are easily serviced.

Blanchard's argument then is that deficit spending has no real fiscal cost. Moreover, the Summers argument takes it further and suggests the benefits of infrastructure spending, of the sort Australia's CEOs want, will soon generate additional tax revenue to cover the infrastructure costs.

# How does the government justify the surplus objective?

We now turn to consider why the Government thinks a return to surplus is a good outcome.

The first justification supposes that, on average, achieving a budget surplus ‘supports the Government’s capacity to respond flexibly to unforeseen events and challenges’ (Australian Government 2019b, p 1.). ‘Flexibility’ is left as an undefined concept and it is not explained how a past surplus can make current policy responses more flexible to current economic conditions. It is meaningless to suggest that a government is in a better position to withstand shocks if it has a ‘stock of financially liquid net assets’; governments are simply not constrained by their cash on hand and credit balances in banks. It is ridiculous to think governments are constrained by the need to have some asset in a vault when government payments are merely computer-generated electronic credits that flow between government agencies and the RBA. In order for these transactions to be accepted, it does not really matter whether the Australian Government has a net credit or debit balance. If there is no need for a strong financial net worth, the surpluses that deliver the net worth are equally superfluous.<sup>23</sup>

The second apparent role of surpluses is also curious: the budget papers assert that ‘A strong balance sheet provides the Government with flexibility to respond to unanticipated events, such as financial crises or economic shocks’ (Australian Government 2019a). This statement might be compared with Hockey who, when Treasurer, said ‘We have no intention of hoarding the strong surplus for its own sake. This money is not ours, it belongs to the Australian people.’ (Hockey 2008, p 10).

This is another case of inappropriately borrowing from business thinking—an inappropriate use of a commercial accounting metric. A private business in an uncertain environment might find it desirable to have a strong balance sheet, which includes a ‘stock of financially liquid net assets’.<sup>24</sup> But this is meaningless with respect to the government, which did not even publish net worth estimates until the 1999–00 budget. It is difficult to understand why

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<sup>23</sup> Note that, in this regard, the IMF encouraged developed countries to adopt an active fiscal policy in response to the global financial crisis almost irrespective of their previous history of budget balances. See International Monetary Fund (IMF 2019b).

<sup>24</sup> Strong reserves can assist a company in the event of its suffering future losses. However, when there are large liquid reserves, companies often experience pressure to return these to their shareholders. Moreover, with a larger debt, many companies can leverage up their profitability when expressed as a return on their own equity.

a concept, neither calculated nor published before 1999-00, has since become an important government target.

When it was first published, net financial worth was estimated at minus \$68 billion or a negative 10.2 per cent of GDP.<sup>25</sup> Thus, the first time it was presented, it was big and negative yet there did not appear to be any particular concern caused by the 'discovery' of this large negative net worth.

Net worth and net financial worth are important, if not critical, measures in the private sector. A company that finds itself with negative net worth is insolvent; it has to desist from trading and put itself under voluntary administration (ASIC 2008). But concepts such as insolvency and its related terms are meaningless in the public sector. Governments do not fail if they cannot achieve sales; they have the power to raise taxes, which no private business can do, and the Australian Government has the ability to print legal tender (and more commonly, puts credits into payees' accounts electronically). Moreover, the value of many items included in the government's net worth is uncertain. For example, valuing an asset such as Parliament House is problematic when there is no market in parliament houses that would guide a valuation. Nor are government assets easily sold. Any attempt to sell Parliament House would most likely require legislation, which might or might not pass the Parliament, and there may well be no buyers.

Occasionally, there are good reasons to run a budget surplus. For example, if the economy is genuinely overheating and there is a need to cool it down, it is appropriate for the government to act to reduce the level of economic activity.<sup>26</sup> Collecting more in taxes, limiting spending and thus increasing the surplus can be very effective at reducing the level of activity in the economy. But that does not mean there is always and everywhere a justification for running a surplus. If the justification for a surplus is as weak as suggested in this paper, how can it be reasonable to endorse an automatic rule about maintaining modest surpluses in the medium to long term? From an active fiscal policy perspective, a perpetual surplus would only be advisable if there were a view that the Australian economy risked perpetual overheating; if not, the case for a surplus simply vanishes. Otherwise the budget balance should be seen as the rather unimportant residual after governments have done everything they need to do to address the real issues facing the Australian people.

## COMPLICATIONS DUE TO SUPRLUSES

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In this section we examine some of the implications of governments running budget surpluses.

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<sup>25</sup> See historic tables in Australian Government (2019a).

<sup>26</sup> We mentioned Keynes's How to pay for the war. Keynes's objective was to contract the rest of the economy so as to free resources for the war effort.

## The private sector loves government debt

Despite the concern about government debt, the market seems to like it with many individuals and companies eagerly purchasing it. Treasury's *Red Book*, the briefing Treasury prepares for the returned government (Treasury 2010),<sup>27</sup> made some interesting comments on the topic of Commonwealth Government Securities (CGS) associated with the 2010 election. The bulk of government debt takes the form of CGS (often just called government bonds), which are sold to investors by the Australian Government. Government bonds serve very useful purposes according to the Treasury:

- they create 'a benchmark risk-free rate' being the rate on financial assets issued by a government that cannot go broke
- the government bond market helps keep interest rates low
- they provide a safe haven for capital during times of instability
- they facilitate government access to the capital market.

It should also be added that government bonds are the preferred financial investment of people who want the absolute certainty associated with a financial asset backed by the government. The Incoming Government Brief points out that, in 2003, the government maintained on issue \$60 billion in government bonds to support the bond and futures market. Indeed, the decision to maintain government bonds on issue reflected 'concerns raised by key financial market stakeholders' (Australian Government 2004). The markets simply needed bonds on issue even though the government surpluses meant it no longer needed to borrow. However, by 2008, it became apparent that the figure of \$60 billion was too low; since then, the value of issued government bonds has increased to \$556 billion in mid-2020 and is expected to increase further in the forward estimates (Australian Government 2019b).

The Treasury brief did not say so, but the value of government bonds has risen because an increased number of them were issued to fund government deficits. The fact that government debt is valued in the market is an argument against never-ending surpluses and maintaining government bonds as a steady share of GDP requires the government to run, on average, a modest deficit. These questions will be important if the government's budget balance returns to surplus. The stock of government debt will normally fall as a result because the surplus is used to pay it off. A budget surplus is itself a mechanism that withdraws cash from the economy as we show in the next section. The very fact that the government is taxing more than it spends withdraws cash from the economy and, generally, ways have to be found to put cash back into the economy. We will see that the government does have plans to address the liquidity drain posed by government surpluses.

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<sup>27</sup> There is also an alternative Blue Book that is prepared in the event the Opposition wins the election. See Treasury (2011).

## Surpluses can suck liquidity out of the system

We pointed out above that surpluses involve taxing the Australian economy more than is needed to finance the government's activities. Associated with a net flow of payments to the government is a drain of the liquidity of the private sector as cash is withdrawn from the economy.<sup>28</sup> Generally this involves a net payment of clearing balances from the private bank to the RBA which involves a drain of bank reserves (a full account is given in Richardson 2015). To compensate for this, governments have to ensure that additional liquidity is pumped into the system.

Governments have to compensate for the private sector cash drain by purchasing financial assets elsewhere,<sup>29</sup> technically a way of re-injecting cash back into the economic system. The government can buy back government debt but eventually that runs out,<sup>30</sup> it is just not possible to maintain a stock of net government debt in the market with perpetual surpluses unless governments take some additional action. By purchasing assets from the private sector in exchange for cash, the government returns cash to the economy. During the Howard/Costello surpluses the Future Fund largely fulfilled that purpose by using the surpluses to purchase assets in the private market and thereby inject liquidity into the system (see Richardson 2004).

So when government debt was dangerously low under the Howard Government, they started to inject liquidity into the Australian economy through purchases of assets on behalf of the Future Fund. Prior to that the Government was able to inject liquidity into the economy by buying back outstanding government debt. That accumulation of shares and other assets resulted in the government building up a large portfolio of financial assets. In effect, it has turned itself into something of a financial institution, with one arm raising funds by running surpluses while another arm is using the funds to purchase financial assets (see Richardson 2004). In this way, the government is acting like an investment bank with an accumulation of \$482 billion in financial assets (Australian Government 2019b). The whole exercise is unnecessary. If the market wants government bonds, the government should oblige by running, on average, a modest deficit. It is not clear that anything useful is served by the government engaging in financial intermediation.<sup>31</sup>

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<sup>28</sup> 'Cash' does not necessarily include notes and coin, although some will be involved. The major impact will be on reserves in the banking system.

<sup>29</sup> Or not running a surplus in the first place. Note third alternative, government purchasing physical assets, is not really an alternative as that implies reducing the surplus.

<sup>30</sup> Or we reach the minimum required by the market.

<sup>31</sup> There have been suggestions that during mining booms the Future Fund act like, for example, the Norwegian sovereign wealth fund which offsets the large monetary inflows from oil revenues by purchasing foreign assets (see Richardson 2010).

In evidence to the House of Representatives Standing Committee on Economics, the then Governor of the RBA, Glen Stevens, pointed out that Australia has been unable to agree to the Basel III standards for bank capital adequacy because the present drafts of that agreement would require the banks to hold large amounts of government debt (Stevens 2010). Australia then could not provide sufficient government debt to satisfy the Basel III standards, a consequence of the running down of the government debt market.

The latest MYEFO says that despite the surplus the Government wants to increase securities on issue over the forward estimates. It said:

At times when AGS issuance is not required to finance the Government's activities, successive Governments have continued to issue AGS for policy purposes such as to maintain a liquid AGS market. While its fiscal strategy includes an objective of reducing gross debt, the Government remains committed to maintaining a well-functioning and liquid AGS market. In particular, the Government will focus on ensuring a market of sufficient size to maintain liquidity across the longer yield curve and to support the Treasury Bond futures market and other important benchmarks (Australian Government 2019b, p. 64).

So basically the market needs more government debt for liquidity in the bond market. However, by maintaining and even increasing government securities on issue the need to reinject liquidity into the system is increased. To many people it may seem ironic that while the present government says its priority is paying down debt it wants to maintain the present actual government debt on issue. It therefore has to use the surplus to buy other financial assets. That is confirmed in the MYEFO which shows total financial assets held by the government increasing from \$482.8 billion in 2019-20 to \$545.4 billion in 2022-23. That will involve acquiring \$62.6 billion in new financial assets.

Under the Howard Government surpluses were actually used to run down government debt to critically low levels as we saw above. This government is now fundamentally different in that it wants to use the surplus to acquire new financial assets.<sup>32</sup> The Government is often loose with their language such as on the 16 December following the MYEFO when the Treasurer referred to paying off debt. Elsewhere he is more cautious and refers to reducing 'net debt' such as the first time debt is mentioned in his 2019-20 budget speech (Frydenberg 2019a).

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<sup>32</sup> You could argue that the surplus should be used to increase Newstart, increase health and education spending and so on. However, each of these actions will reduce the surplus as each would be measured as a government expense or payment.



# The government as an investment bank

Using the surplus to buy new financial assets seems a strange strategy for a government so intent on reducing debt and seemingly wanting small government in other respects. A lot of the new financial assets are likely to end up being held in the Future Fund, but it is not obvious that the government has a clear strategy behind building up the Commonwealth as a type of investment bank. Nevertheless, the latest figures show total government securities on issue are \$556 billion or 27.7 per cent of GDP. The amount on issue is expected to increase to \$576 billion in mid-2023 which shows the surplus is not being used to reduce government debt on issue but just reduce net debt. Net debt is smaller at \$392 billion or 19.5 per cent of GDP and is expected to fall to \$361 billion in mid-2023.<sup>33</sup> The difference between gross and net debt is \$164 billion or 8.2 per cent of GDP and we can think of the difference as the financial assets owned by the government and funded by an excess issue of government securities. A lot of this \$164 billion will be the assets included in the Future Fund (see below).

If we examine the commercial and financial aspects of the government's financing activities we find that the government will be close to breaking even by the end of the forward estimates. The relevant figures are shown in Table 2 which gives interest expenses on the one hand and interest and dividend receipts on the other hand. Table 2 then shows the income and expenses associated with the items that might make up the financial and equity assets in the government's balance sheet.

**Table 2: The government's performance as an investment bank (\$m)**

	2019-20	2020-21	2021-22	2022-23
1 Interest expenses	16,564	15,279	14,726	13,900
2 Interest receipts	5,134	6,060	6,376	6,632
3 Dividends	6,383	5,521	5,697	5,738
4 Net investment income position	-5,047	-3,698	-2,653	-1,530

Source: (Australian Government 2019a).

An examination of Table 2 shows that the government is close to breaking even on its net income/expense from holding the assets and liabilities that generate the items reported in Table 2. Over the forward estimates the net position will move from a \$5 billion deficit to a much smaller \$1.5 billion deficit.

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<sup>33</sup> Estimates in this paragraph from Australian Government (2019b).

When the Treasurer refers to the reduction in interest payments he is of course only talking about the first line in Table 2. He talks about getting it down from \$19 billion last year to \$14 billion at the end of the forward estimates. However, given the financial strategy painted in this section *net* interest payments are soon to be a trivial issue. Obviously it must be a deliberate strategy to run the government finances as an investment bank, especially via the Future Fund, so the Treasurer should be talking about the net result rather than the gross figure for interest on government debt.

## The Future Fund

In discussing the Future Fund it is worth noting that it was established to finance the so-called 'unfunded superannuation liabilities' of the Commonwealth. The 2006 Budget Papers explained:

the establishment of the Future Fund, in which funds will be gradually accumulated [is] to meet the Commonwealth's superannuation liability — the largest liability on the Government's balance sheet (Australian Government 2006).

To that end the Government added a change to its budget accounting by excluding future fund earnings from receipts when calculating the 'underlying budget balance'.<sup>34</sup> That then gave a misleading figure for the budget balance. However, from 2020-21 earnings of the Future Fund are to be added back into the budget balance and the Budget Papers explain that by saying:

under the Future Fund Act 2006, net Future Fund earnings will be available to meet the Australian Government's superannuation liability in 2020-21. From this time, the underlying cash balance includes expected net Future Fund earnings (Australian Government 2019a).

All this is really a bit of trickery using an artificial partitioning of the relevant assets and liabilities into the Future Fund and a partitioning of the associated income and expense flows. That is abundantly clear now that the need for the Future Fund is apparently over but both the Future Fund and the unfunded superannuation liabilities are included in the Budget Papers unchanged as separate items. Indeed, the 2019-20 Budget Papers still refers to 'unfunded superannuation liabilities' (Australian Government 2019a) and these are expected to persist over the forward estimates. In the meantime, the presence of the Future Fund never changed other measures of the budget in either cash or accrual terms. Government payments to superannuants and the future fund are two items in the budget papers but otherwise never had any relationship to each other.

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<sup>34</sup> This is the main measure that is used to summarise the budget position; it is quoted by Treasurers in their budget speeches and by the press commentary.

We mentioned earlier there seemed to be no clear strategy in building up financial assets, but there could be. In Singapore Temasek holds enterprises on behalf of the government including well-known companies such as Singapore Airlines, DBS Bank and Singtel. If NBN Co were held in the Future Fund it would mean the government need not directly manage its ownership of NBN Co. Likewise the government could offset foreign holdings of government bonds with a foreign portfolio (which it does to some extent).

# Conclusions and reflections

There has been bipartisan support for a target of budget surpluses, yet the various governments were proud of stimulus packages when required and had no compunction in jettisoning the surplus in the context of natural disasters such as the bushfires in the summer of 2019-20. However, it would appear that the stimuluses were meant to be no more than a temporary distraction from the surplus strategy.

The Rudd/Swan stimulus was opposed by the Opposition on the grounds that it would add to Australia's debt but that looked trivial by comparison with the country's own historical debt levels and the situation in the rest of the world. IMF calculations showed Australia with debt at 20 per cent of GDP compared with most economies at well over double that and many with 75 per cent or more (IMF 2019a).<sup>35</sup>

The Australian surplus target is associated with a taxation cap of 23.9 per cent per of GDP. Since those two commitments together involve a considerable restriction on what a government can do, it is important that the rationale behind the measure is properly examined. There should be a very good reason for the intention to tax more than is necessary to fund government spending. At best, it appears that the rationale for government surpluses is a misplaced application of commercial business principles.

The alternative view put here is that the budget balance should not be set according to vague and untested notions such as 'sound finance' but should instead reflect the needs of the economy. Macroeconomic demands should determine the stance of fiscal policy.

Over time, an apparent obsession with budget surpluses has developed, which is reflected in recent budget papers. There are theories to the effect that surpluses enable governments to respond more flexibly to future circumstances and that a strong 'government balance sheet' is important. Although the analogy with the private sector can be appreciated, its application to government is found to be invalid. There is also intergenerational equity, the idea that governments should not burden future generations, but even that does not stand up to scrutiny. The pattern of assets and liabilities in the public and private sectors now is unlikely to have any impact on the income earned in the future. Payments made by government in servicing its debt are someone else's income—there is no net burden.

Overall, this paper finds that the conventional political wisdom on the virtues of surpluses, together with the evils of deficits and debt, is not supported by sound economics. The current generation of decision-makers have had to re-learn this lesson. People appear to borrow analogies from the commercial world when it suits them but support fiscal rules

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<sup>35</sup>The latter included in descending order, Japan, Italy, Portugal, France, Belgium, Spain, the US, and UK.

imposing spending restraints in a way that no commercial organisation could tolerate. As it happens, there is a healthy demand on the part of the financial markets for government debt in the form of bonds and, on that count alone, at least some of the government debt must be a 'good thing'.

There seems to be a dangerously flawed logic behind the view that Australia should aim for a perpetual surplus of 'at least one per cent of GDP'. As we saw earlier, returning to such a surplus would mean that the average taxpayer is paying at least \$1,700 per annum or \$33 a week more than is needed to finance the government.

Meanwhile, the government is sometimes less than clear. When it wants to talk about reducing the deficit it refers to net debt not gross debt which is actually increasing. When it wants to talk about the need for austerity it refers to the gross interest cost while ignoring the financial income it receives on its financial assets. It seems convenient for the Government to refer to net debt and gross interest costs not acknowledging that net financing costs will be trivial by the end of the forward estimates.

At any time, the fiscal balance should be decided by a pragmatic concern for government priorities and reaction to the needs of the economy and society. Those priorities should not be held hostage to arbitrary targets for the fiscal balance. One might even conclude that much of the surplus, deficit and debt discussion is designed to head off proper debate about the role of government in society. The flimsy nature of the argument for surpluses is apparent when the target was jettisoned following the bushfires. That raises the question of when does the government actually think it appropriate to jettison the surplus target.

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