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Surplus fetish

The political economy of the surplus, deficit and debt

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Policy Brief

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> In the present situation of a temporary slowdown in economic growth, an easing in the fiscal position is appropriate as it helps to support demand growth in the economy.[1]

1. Introduction

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. But often these concepts are applied uncritically and inappropriately. By way of discussing the budget balance—surpluses, deficits and the debt outcome—this paper addresses some of those inappropriate usages and their consequences.

During the recent election campaign, both sides of the political debate paid 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, and continue to do so. Budget one-upmanship has moved beyond the balanced-budget obsession of the 1990s to the new aim of producing an ongoing surplus, the bigger the better, under which it is taken for granted that everyone will be better off. Accordingly, the main focus of the economic debate is about bringing in a surplus as big and as soon as possible, preferably at least one per cent of GDP.[2] However, as will be shown, 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 $1300 more than is necessary to fund 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 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'.[3] 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.[4]

But now, with that episode over, the Gillard Government has again endorsed a return to surplus. The Opposition never agreed with the size of the stimulus and, during the 2010 election, favoured immediate spending cuts and advanced a plan to return to surpluses far more quickly than the government. Ever since the global financial crisis, the Opposition has run fear campaigns directed at Labor's stimulus measures. One of the Liberal Party campaign slogans was 'Labor's debt is growing by $100 million a day, every day'. The Opposition promised to repay the debt, which, as discussed below, can only mean a more rapid return to surplus.

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1. Australian Government, *Statement 1: Fiscal strategy and budget priorities 2001–02, Budget Paper No 1*, Canberra, May 2001, p. 3.
2. Australian Government, *Statement 3: Fiscal strategy and outlook 2010–11, Budget Paper No 1*, Canberra, May 2010.
3. 'Troubles ahead for world economy', transcript of interview with J Stiglitz by K O'Brien, *The 7.30 Report*, 27 July 2010.
4. This is based on the 2009 budget estimate of unemployment at 8.5 per cent for 2010–11 compared with the present level (five per cent) and assuming employment and GDP change in the same proportions. See ABS, *Labour Force, Australia, Jul 2010*, Cat no 6202.0, 12 August 2010; Australian Government, *Statement 1: Budget overview, 2009–10*, Budget Paper No 1, May 2009.

The notion that a big 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; that is, the last thing 'the markets' want is the complete abolition of public sector debt. Indeed, at times, they have lobbied for more.

Before continuing, a common misunderstanding needs to be clarified—government surpluses, debt and deficits have nothing to do with *Australia's foreign debt* but there is potential for confusion. On 9 February 2010, the Opposition's then finance spokesperson, Senator Barnaby Joyce, went further and said on the ABC's *The 7.30 Report*:

> 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.[5]

Barnaby Joyce appears to be confusing government debt with Australia's foreign debt. Australia's foreign debt is large and it is a concern,[6] 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 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'.[7]

2. 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.

The historically and internationally low level of Australia's debt was confirmed by Glenn Stevens, the Governor of the Reserve Bank of Australia (RBA), who said that public debt in Australia is both low and 'largely unavoidable'.[8] He is surely right on the 'low' point— on current forecasts, Commonwealth debt will be $80.6 billion in mid 2011, which, while seemingly large in absolute terms, is only 5.7 per cent of GDP.[9] 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 $1390 billion in today's equivalent. Figure 1 graphs Australia's gross government debt to income ratio from

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5 'Abbott echoes Obama's election catchcry', transcript, *The 7.30 Report*, 9 February 2010. Available at http://www.abc.net.au/7.30/content/2010/s2814882.htm

6 The latest figures put Australia's foreign debt at $671.9 billion or 52.9 per cent of GDP. See Australian Bureau of Statistics (ABS), *Balance of Payments and International Investment Position, Australia, Jun 2010*, cat. no 5302.0, Canberra, 31 August 2010.

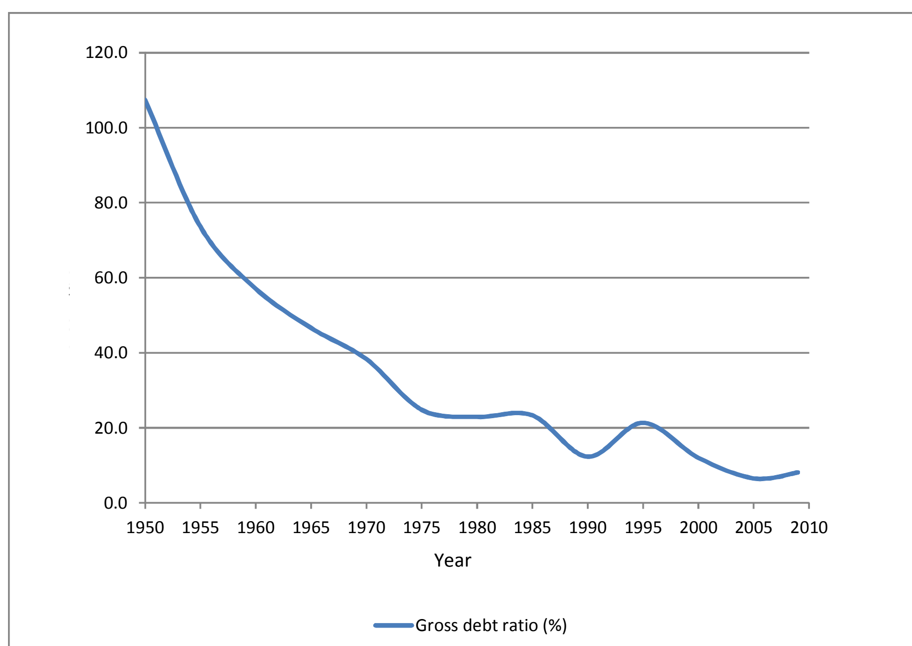
7 The possibility that the government can borrow externally is not considered in this paper for two reasons. First, when Paul Keating was Treasurer, the government stopped its overseas borrowing program (See P Martin, *Ken Henry's public service survival tip—think long and hard before doing good things that might look bad*, Tuesday column, 13 February 2007), the overseas debt was paid out as it retired and there are now only nominal amounts remaining (See Australian Office of Financial Management, 'Historical data: Commonwealth Government Securities on Issue', 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 Australian Bureau of Statistics (ABS), *Balance of Payments and International Investment Position*.

8 L Dodson and M Dunkley, 'Abbott wields spending axe to regain traction', *The Australian Financial Review*, 21 July 2010.

9 Australian Government, *Statement 10: Historical Australian government data 2010–11*, Budget Paper No 1, Canberra, May 2010.

1950 to 2009,[10] using government debt at both the Commonwealth and state and territory levels.

Figure 1: Gross debt to GDP ratio



Source: Reserve Bank of Australia;[11] ABS[12,13].

As can be appreciated from Figure 1, Australia's gross debt to GDP ratio is just above its post-war low. Note that the data behind Figure 1 refer to *gross debt*; net debt[14] figures are not available for the whole post-war period and the gross figures will overstate the net position somewhat.[15] 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 net government debt and compares it with the debt in other major countries, expressed as a ratio of debt to GDP.

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[10] This graph plots government securities on issue as a share of GDP so as to keep it comparable to the earlier RBA historical tables.

[11] Reserve Bank of Australia (RBA), *Australian Economic Statistics 1949-1950 to 1996-1997*, Occasional Paper No 8, 1997.

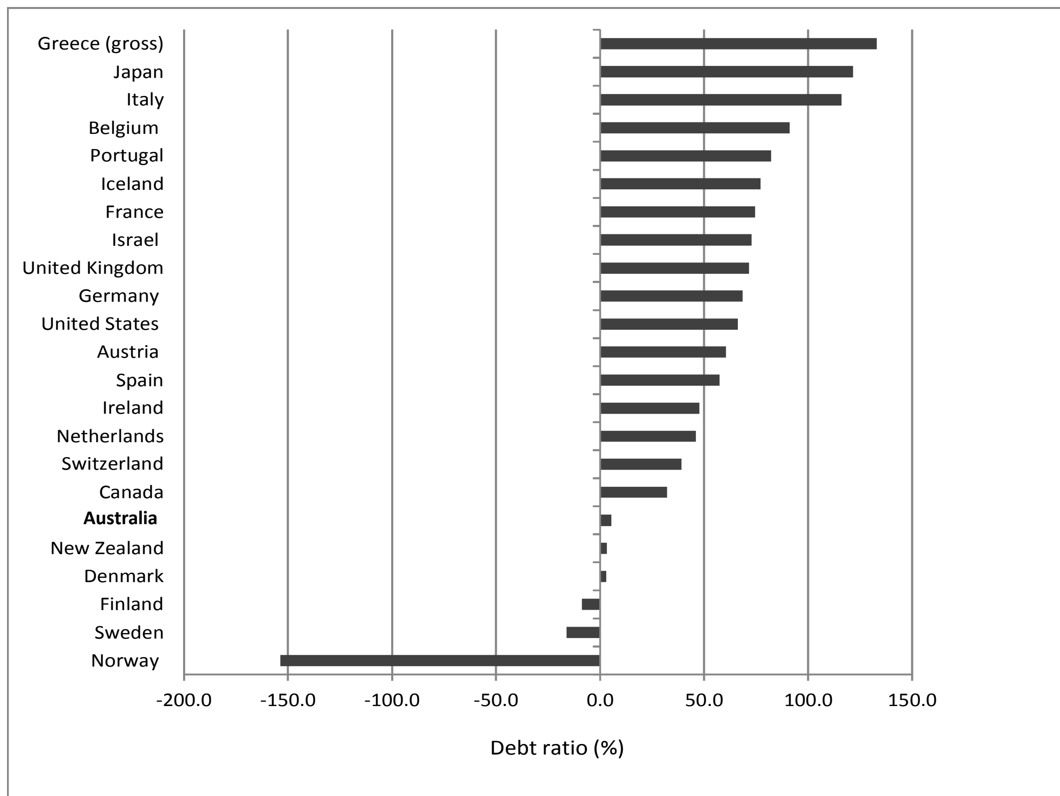
[12] ABS, *Australian National Accounts: National Income, Expenditure and Product, 30 June 2010*, cat. No. 5206.0, Canberra, 1 September 2010.

[13] ABS, *Government Finance Statistics, Australia, 2008–09*, cat. no. 5512.0, Canberra, 27 April 2010.

[14] Net Commonwealth debt is gross debt less financial assets held by the Commonwealth.

[15] 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.[16]

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 5.4 per cent, as calculated by the IMF.[17] Indeed, Australia's debt at 5.4 per cent is barely evident in Figure 2. At worst, Australia's debt ratio is a tenth of that in the typical advanced economy and, in addition, it is expected to peak at 6.4 per cent of GDP in 2011–12,[18] barely above its present value. By contrast, most advanced economies are expected to experience further large increases in their debt ratios.

Before leaving this section, it is important to point out that movements in net debt reflect more than just the budget balance. Governments are able to artificially lower net debt by selling physical assets. The Howard Government, for example, reduced debt by $45 billion as a result of the sale of Telstra and other major government assets,[19] 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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[16] International Monetary Fund (IMF), *Fiscal monitor: navigating the fiscal challenges ahead*, Fiscal Affairs Department, April 2010.

[17] The outlier is Norway with a massive *negative* debt. As a result of its immense petroleum income, Norway has accumulated a vast stock of financial assets.

[18] ABS, *Australian National Accounts: National Income, Expenditure and Product, 30 June 2010*.

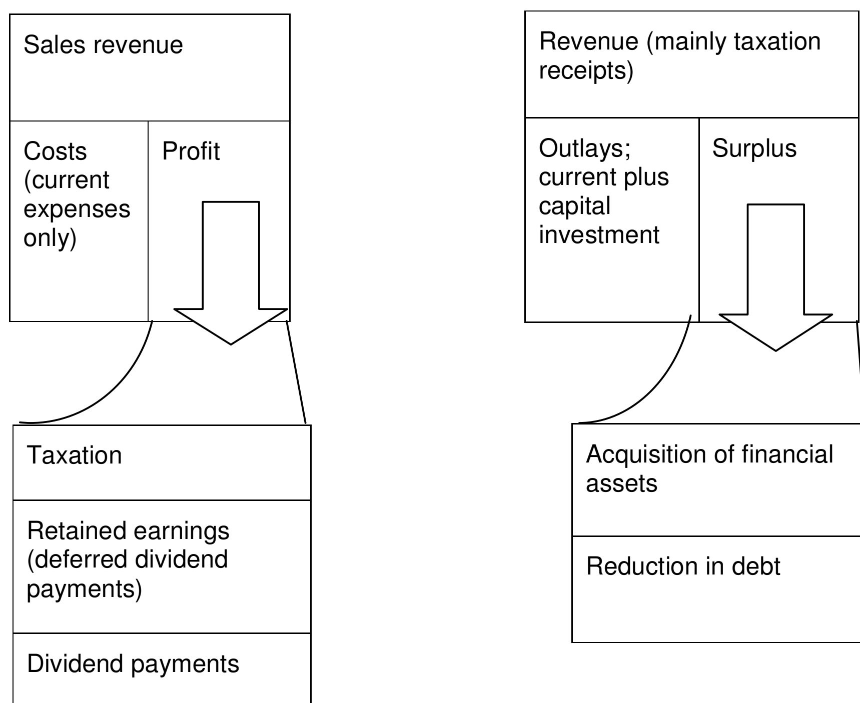
[19] A list of asset sales going back to 1988 is maintained by the Department of Finance and Deregulation.

3. Surplus thinking

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 or investments that, for various reasons, are better performed by government. The pursuit of a budget surplus is therefore the pursuit of excessive tax collections relative to the desired level of public spending.

The following figure 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.[20]

Figure 3: Spending and revenue: Private vs public treatment



Note: Investment is not included in the company's operating statement

[20] 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, *Statement 3: Fiscal strategy and outlook 2010–11*.

Figure 3 allows a comparison of the flows into and out of the corporate and public sectors. Both diagrams show 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 the next level, 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. At the same level, 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.[21] If the public sector spends less than its revenue, it produces a surplus.

The diagram 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',[22] 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.

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 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 to contractors is unambiguously good for a company, but paying lower pensions to pensioners is not unambiguously 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 benefit, two items (treated as an expense rather than as a dividend) that both reduce the surplus.[23] This example 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.

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[21] 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.).

[22] '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.

[23] It could be returned in kind through additional spending on education and health, but that would also eliminate the surplus.

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, which appear to reflect the view that a government surplus is indeed a valuable target of public policy. For example, despite the success of the stimulus package, the 2010 budget papers announced that the government is determined to return to surplus and has imposed a two-per-cent spending growth limit to assist it to do so. As the budget papers explain:

> The focus of the fiscal strategy will remain on returning the budget to surplus, including by constraining real expenditure growth to 2 per cent and by allowing the level of tax receipts to recover naturally with economic recovery. Once the budget returns to surplus, and while the economy is growing at or above trend, the Government will maintain expenditure restraint by retaining a 2 per cent real annual spending cap, on average, until surpluses are at least 1 per cent of GDP.[24]

Thus, until the budget returns to surplus, the government intends to maintain a tight limit on spending in the short term, which will impose a massive constraint on what activities it can undertake by way of health, education, the environment and other initiatives.

The short-term spending restraint until the surplus is reached also has to be read in the context of a long-term commitment to 'keep taxation as a share of GDP below the 2007–08 level, on average'.[25] That level was 23.6 per cent of GDP. The date is completely arbitrary and there is certainly no 'science' that would suggest that 23.6 per cent is just the right tax to GDP ratio or, indeed, that 2007–08 was the best year to use as the base.

Nevertheless, the government has announced 23.6 per cent as a long-run commitment and, by keeping tax constant as a share of GDP and producing a surplus, there is an effective, although arbitrary, long-term restraint on spending. However, both the short-term and long-term spending restraints seem designed to conceal the choices available to voters. There is no logic to keeping taxation at the 2007–08 level of 23.6 per cent of GDP.[26]

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. Unfortunately, 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.

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[24] Australian Government, Statement 3: Fiscal strategy and outlook 2010–11.

[25] Australian Government, *Statement 3: Fiscal strategy and outlook 2010–11*, pp. 3–4.

[26] The target seems to be something that crept into the debate as a mere assumption of constant tax to GDP ratios. See Australian Government*, Australia to 2050: Future Challenges. The 2010 intergenerational report overview*, Canberra, January 2010. Those who advocate a return to surpluses as an iron rule of government policy are similar in many respects to the now discredited monetarists, who suggested governments should eschew an active monetary policy but should instead adopt a strict rule and limit the growth in the money supply to a small annual percentage increase. The monetarist experiment failed with serious consequences including high unemployment rates.

To spend or not to spend?

Rules such as limiting spending growth to two per cent have further consequences. If something is worth doing it should be done, whether it is in the private sector or the public sector; however, by imposing a spending limit, projects that may be commercially viable are likely to be dropped merely because there is a limit on total spending.

Significantly, private companies never adopt rules that would limit their ability to invest in a profitable project. A rational private company is quite prepared to borrow and invest in a project that is expected to generate a net return. Governments should also follow that approach and judge a spending project on its intrinsic merits. It appears that there is a certain selectivity about when and how private sector approaches are advocated for government.

Projects or programs that may not be commercially viable may nevertheless generate net benefits for the country. On normal cost-benefit grounds they should be adopted, but are potentially ruled out when arbitrary spending limits exist. Limits on spending necessarily imply ruling out otherwise beneficial programs.

4. 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 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.[27]

Briefly, the active fiscal policy hypothesis calls for a budget balance that is whatever it needs to be to achieve full employment without inflation (within limits). 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 measures are called for where 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*.[28]

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[27] 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 was the most prominent. See A Lerner, *The Economics of Employment,* New York, McGraw Hill, 1951.

[28] J M Keynes, *How to Pay for the War: a Radical Plan for the Chancellor of the Exchequer*, London, Macmillan 1940.

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; 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.[29,30]

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 the active fiscal policy. It is worth quoting the 2009–10 budget paper:

> The 2009–10 Budget has been framed against the backdrop of the deepest global recession since the Great Depression. Early and decisive policy action by the Australian Government and the Reserve Bank of Australia is helping to support the Australian economy.
>
> … the Government's fiscal stimulus program started with income support and then moved into 'shovel-ready' infrastructure.

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[29] Australian Government, *Statement 1: Fiscal strategy and budget priorities, 2001–02.*

[30] 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.

> The infrastructure projects announced in this Budget lay the foundations for a stronger future economy, supporting employment now and positioning Australia to take full advantage of the global recovery when it comes.[31]

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.

But despite the government's endorsement of an active fiscal policy at the time of the global financial crisis, with that in the past it now also advocates returning to a surplus with restrictions on the growth of government expenditure. Indeed, during the election campaign, the Treasurer was reported as saying in response to TV interviewer David Koch: 'We're getting back into surplus in three years, Kochie … Come hell or high water, but we've got the judgment to handle these situations'.[32] Nevertheless, whenever Australia faces major macroeconomic problems, the government seems to adopt an active fiscal policy stance as the examples here show.

5. How does the government justify the surplus objective?

Despite the success of the stimulus package in response to the global financial crisis, the Gillard Government continues to target a return to budget surpluses, as mentioned above. A return to surplus is not a problem *per se*, but it is not clear at present that the outlook for the economy justifies a quick return to a substantial surplus.

Justifications for the pursuit of a surplus were outlined by Wayne Swan in his first budget and appear to be twofold, although a third based on intergenerational considerations is sometimes raised. Intergenerational considerations are dealt with in a separate section below. In this section, the arguments for pursuing a one-per-cent surplus are critically evaluated.

1. The first justification supposes that, on average, achieving a budget surplus 'provides necessary flexibility for the budget balance to vary in line with economic conditions'.[33] '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.
2. The second apparent role of surpluses is also curious: the budget papers assert that '[s]urpluses over the medium term also contribute to a strong government balance sheet' and that the government's 'ability to withstand adverse economic shocks is [dependent upon] its available stock of financially liquid net assets'.[34]

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

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[31] Australian Government, *Statement 1: Budget overview, 2009–10.*

[32] P Martin, 'Swan takes levy of his commonsense', *The Sydney Morning Herald*, 26 January 2011.

[33] Australian Government, *Statement 3: Fiscal strategy and outlook 2010–11,* p. 3–3.

[34] Australian Government, *Statement 3: Fiscal strategy and outlook 2010–11*, p. 3–3–4.

[35] 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.

When it was first published, net financial worth was estimated at minus $68 billion or -10.2 per cent of GDP.[36] 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.[37] 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. 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.

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. These days, government payments are merely computer-generated electronic credits that flow between government agencies and the RBA and, 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.[38]

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. 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.

6. But 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,[39,40] made some interesting comments on the topic of Commonwealth Government Securities (CGS). The bulk of government debt takes the form of CGS (often just

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[36] Australian Government, *Statement 10: Historical Australian government data 2010–11.*

[37] Australian Securities & Investments Commission (ASIC), *Insolvency: A guide for directors*, Information Sheet 42, December 2008.

[38] 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), *World Economic Outlook: Crisis and Recovery*, World Economic and Financial Surveys, Washington D C, April 2009.

[39] The Treasury, *Freedom of Information Requests for the Treasury Incoming Government Briefs*, press release, 24 September 2010.

[40] There is also an alternative *Blue Book* that is prepared in the event the Opposition wins the election. See The Treasury, *2010 Treasury incoming government briefs—Update*, Canberra, 25 March 2011. Available at: http://www.treasury.gov.au/contentitem.asp?ContentID=1875&NavID=007

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'
- 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.[41] 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 $151 billion at August 2010[42] and is expected to peak at $210 billion in 2012–13.

The Treasury brief does 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, as expected, 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[43] from the economy; 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 it back.

Because the surplus takes cash out of the economy, governments have to compensate by purchasing financial assets elsewhere, technically a way of re-injecting cash back into the economic system. The government can buy back government debt but eventually that runs out;[44] 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.

Previously, this was done through purchases on behalf of the Future Fund, which accumulates shares and other assets and, as a result, the government has built 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.[45] In this way, the government is acting like an investment bank with an accumulation of $219 billion in financial assets.[46] 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.

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41 Australian Government, *Statement 7: Budget funding, 2004–05*, p. 7–2.

42 Reserve Bank of Australia (RBA), 'Statistical tables: government finance', [Table] E3, March 2011.

43 'Cash' does not necessarily include notes and coin, although some of them will be involved. Also included are reserves in the banking system.

44 Or we hit the minimum required by the market is reached.

45 For more discussion see D Richardson, *The 2004 Budget: Some issues arising*, Parliamentary Library Current Issues Brief No 6, 2004–05, 9 August 2004.

46 Australian Government, *Final Budget Outcome 2009–10*, Canberra, September 2010.

In evidence to the House of Representatives Standing Committee on Economics, the 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.[47] Australia simply cannot provide sufficient government debt to satisfy the Basel III standards.

7. Super liabilities as government debt?

Despite the government's apparent aversion to debt, there is really no unambiguous way of measuring it and arbitrary changes to the definition can bring it into existence or get rid of it. Government figures for net government debt published in the budget papers are derived by subtracting total financial assets from total liabilities and, if the answer is negative, there is said to be net government debt. The budget papers show net financial liabilities of $145 billion at June 2010; however, one of the large items included in that calculation was the superannuation liability (and other employee liabilities) of $133 billion.

The estimated future superannuation liability has not always been included in the measurement of government liabilities, so it is to be hoped that there are good reasons for including it now. It comprises the estimated future value of the government's obligations to pay out superannuation to its own employees and, if it had had not been included in 2010, the net financial liabilities in June 2010 would have been negligible at $13 billion compared with the reported figure of $145 billion.

Every year the government pays out around $3.5 billion in superannuation benefits to retired public servants and notionally spends around $3.7 billion in super contributions. The latter are already included as costs in the accrual budget balance and, in effect, they are financing a notional account so that eventually super benefits can be paid. Thus, superannuation is roughly self-financing and, if all future expected super contributions were deducted from expected payouts, there would be (approximately) no liability and maybe even a small credit item.

However, the superannuation liability is an estimate of the future value of *all* superannuation entitlements due to public servants and the military.[48] It is rather curious that superannuation is listed as a liability of $133 billion when the scheme appears to be basically self-financing. To present the real position, the equivalent estimate for expected future superannuation contributions should have been deducted, which will possibly give a very much smaller figure that may not be a negative at all. So the debt figures are likely to be distorted if future payouts are treated as a liability but future contributions are not handled in an equivalent way.

Clearly, it is an arbitrary decision as to which items are included in the debt figures. But it is important to understand why the choice of items may be inappropriate and the simple point is that, if future government spending is to be defined as a liability, future taxation receipts should really be deducted. But the fact that government debt appears to be such an arbitrary concept is yet another reason to question why there should be such concern about the present figures.[49]

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[47] Stevens, G (2010). Testimony to House of Representatives Standing Committee on Economics, *Official Committee Hansard*, Friday, 26 November 2010.

[48] The estimates are discounted so that the payout in a particular year is the value of the amount the government would have to put away now in order to accumulate a balance equivalent to that payout.

[49] At the very least it would seem that all the notional liabilities should be stripped out of the debt calculations before they can be trusted.

8. Intergenerational equity?

As mentioned earlier, the budget papers also refer to intergenerational equity as a reason for running surpluses and paying down debt. For example, the 2008 budget papers attempt to explain how intergenerational equity figures in the thinking behind the budget. The following passages are relevant:

> To be sustainable, an economy needs to improve both efficiency and intergenerational equity. … Intergenerational equity means future generations should always expect to be no worse off than previous generations.
>
> More resources means governments are better able to redistribute within and between generations.
>
> A key way governments impact on economic sustainability is through their fiscal policy. In particular, fiscal sustainability is important for delivering sustainable improvements in living standards over time. Fiscal sustainability can be defined as the ability of government to manage its finances so it can meet its spending commitments, both now and in the future.[50]

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?[51]

The notion that 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.[52]

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

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[50] Australian Government, *Statement 3: Fiscal strategy and outlook*, 2008–09, Budget Paper No 1, May 2008, p. 3–21.

[51] M Turnbull, 'Rudd's debt to burden future generations', *Sydney Morning Herald*, 1 August 2009.

[52] Depending on the actual pattern of interest payments and taxation there may well 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.

those with high tax liabilities.[53] 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.

9. Conclusions and reflections

There has been bipartisan support for a target of budget surpluses, yet the Labor Government was proud of its stimulus package, which sent the budget into deficit through both automatic mechanisms and a deliberate spending strategy. However, it would appear that the stimulus was meant to be no more than a temporary distraction from the surplus strategy.

The 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 5.4 per cent of GDP compared with most economies at well over 50 per cent and many with 75 per cent or more.[54]

The Australian surplus target includes a real expenditure constraint of two per cent per annum once the stimulus is out of the way. Since that commitment involves 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, and especially since the ideological approach of the Howard Government, 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. A society in 40 or 50 years time may well have concerns about

[53] 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. As pointed out in Note 7 above, government debt that is held externally is excluded.

[54] International Monetary Fund (IMF), *Fiscal monitor.*

the distribution of wealth and income in the future but that is rightly a concern for that generation and completely irrelevant to the question at hand.

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 economics. People appear to borrow analogies from the commercial world where it suits them but support fiscal rules 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 are also definitional problems with several of the concepts. For example, some future spending commitments can be aggregated and categorised as a large liability to make the government balance sheet appear dramatically worse than it is. The present government chose to do this with the superannuation entitlements of public servants, increasing its debt by $133 billion. However, it could also have added the age pension and raised the debt by a further $3100 billion. That would have looked ridiculous, but the principle holds—if superannuation entitlements are not counted as a liability, the government debt largely disappears.

There seems little logic behind the view that Australia should aim for a perpetual surplus of 'at least one per cent of GDP'. As mentioned earlier, returning to such a surplus would mean that the average taxpayer is paying at least $1300 per annum or $25 a week more than is needed to finance the government. 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 a fiscal balance. One could almost conclude that much of the surplus, deficit and debt discussion is designed to head off proper debate about the role of government in society.

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