

Debt won't hurt us

...one person's debt is another person's asset; or as I equivalently put it, debt is money we owe to ourselves — an obviously true statement that, I have discovered, has the power to induce blinding rage in many people (Krugman 2015).

David Richardson

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Summary

Treasury forecasts unemployment rising to 10 per cent in the June quarter and that without the JobKeeper allowance unemployment would be 5 per cent higher at 15 per cent. The Government responded with a series of spending packages with a cumulative total of \$193.6 billion. That inevitably means more deficit spending over and the next six months and probably well beyond that.

This paper presents the analysis that shows why we should not fear the likelihood of further debt. To begin with, official interest rates are at record lows and governments around the world have taken advantage of that. The Governor of the Reserve Bank told Four Corners 'we shouldn't be worried...our interest rates are as low as they've ever been'. Chris Richardson is reported as saying: 'Never in the 2000 years of recorded history of interest rates has it been cheaper for governments to borrow'.

As an aside Mike Keating points out that the amount of debt might have been much greater if the Government had not taken action to limit the spread of the Covid-19 virus and to maintain the capability of the economy during the lockdown. There is also the fear debt has to be repaid. Of course, government debt is also a financial asset for those who hold it and maybe they do not want to liquidate their financial assets. If so it is easy for governments to roll over the debt. When a government security matures the government debt is extinguished and in return you receive a payment from the government for the principal value of the security. But in reality you have exchanged one form of government debt for money which is a liability of the Reserve Bank of Australia (RBA). And then the government or the RBA is likely to want to mop up that liquidity by selling bonds which essentially rolls over the original debt.

People also ask 'where is the money coming from?' We show that the additional flow of stimulus spending increases the value of financial assets that the community is happy to hold and those financial assets are equal to the government deficit over that period. Initially the new financial assets are just in the form of additional deposits in people's bank accounts. It goes without saying that no one is forced to do accept money from the government or anyone else. The people who end up holding the debt of the government, in cash or securities, do so voluntarily. So deficit spending itself creates the additional money/liquidity in the system which is used to buy government debt.

On this topic it is also useful to make some historical and overseas comparisons. In 1950 government debt was 107 per cent of GDP or approximately \$2,080 billion relative to today's economy. By contrast Australia's debt is now close to its historic lows. Also, Australia's debt, as measured by the OECD, is just 20 per cent of GDP which is well below

the levels in other economies where debt ratios tend to be from 50 per cent or much more and well above the Australian rate.

A lot of people raise issues of intergenerational equity. The first point to note is that if our children or grandchildren repay some of the national debt these payments will be made to our children or grandchildren and to nobody else. Taking them altogether they will no more be impoverished by making the repayments than they will be enriched by receiving them. Likewise the interest paid by our children and grandchildren will be received by our children and grandchildren. Yet Treasury and the Department of Finance fall into a muddle. The budget papers refer to intergenerational equity as a reason for running surpluses and paying down debt. While passing on paper debts/assets imposes no net benefit or burden there is a stark comparison with public assets such as the Sydney Harbour Bridge and environmental quality of Australia's river systems that can indeed be passed from generation to generation.

Oliver Blanchard has recently put the pragmatic argument that increasing government spending for most economies is costless. With the simple passage of time that debt will fall as a share of GDP.

Another argument goes further and suggests public investment is essentially costless. Estimates suggest each dollar of government spending on infrastructure increases output by nearly \$3, which of course implies higher tax receipts very soon and well into the future.

In the context of debt the word 'sustainability' is often bandied around but it is rarely is it clear what that means. We show that the government is always heading towards an equilibrium level of debt to GDP equal to the rate of savings divided by the nominal rate of growth. At present that ratio is around 5.5. If business investment (along with net exports) is insufficient to absorb the full employment level of savings then government deficits are required to do the job. Government debt in that scenario is not only sustainable but inevitable.

Much of the discussion has implications for economic growth. A particularly influential paper by Reinhart and Rogoff purported to show that higher government debt ratios were associated with lower economic growth and that economies with debt ratios above 90 per cent experience an even greater reduction in economic growth. Other researchers could not replicate the results using the same data sets and found a host of errors in the study. The conclusion is that there is no evidence suggesting that government debt is bad for economic growth.

Introduction

Six or eight weeks of the COVID-19 crisis have robbed us of all superlatives. The IMF now refers to the present period as the ‘Great Lockdown’ and has said:

It is very likely that this year the global economy will experience its worst recession since the Great Depression, surpassing that seen during the global financial crisis a decade ago (IMF 2020).

That almost seems like an understatement compared with some of the hyperbole. The Treasurer, Josh Frydenberg (2020), has released Treasury forecasts that point to unemployment rising to 10 per cent in the June quarter. The JobKeeper allowance will mean that many people who would have been unemployed will instead retain their employment. Frydenberg says that without that measure unemployment would be 5 per cent higher at around 15 per cent (Frydenberg 2020).

The Government has now responded with a series of three spending packages with each seeming to approximately double the previous week’s package reaching a cumulative total of \$193.6 billion by 30 March (Morrison 2020). The fiscal impact of the three packages is summarised in Table 1. In Table 1 a positive number indicates a measure that increases the deficit whether through direct spending measures or tax reductions. Things are happening quickly and on 2 April the Government added another \$1.6 billion with its child care package. That has not been included in Table 1 since we cannot allocate that amount to individual financial years.

Table 1: Commonwealth fiscal measures to 31 March (+ve numbers indicate stimulatory measures)

The Australia Institute Research that matters.	\$ billion
2019-20	65.8
2020-21	126.3
2021-22	6.0
2022-23	-1.1
2023-24	-3.2
Total	193.8

Source: Morrison S (2020) *Economic Response to the Coronavirus*, 31 March.

Table 1 includes some negative figures for 2022-23 and 2023-24 which may look strange. They reflect some measures that were designed to bring forward tax concessions for investment. By bringing the tax concessions forward there are fewer tax concessions in later years so those figures fall by the amounts indicated.

The IMF (2020) makes it clear that countries will need to maintain fiscal stimulus after the crisis and to ensure recovery from the crisis. That inevitably means more deficit spending well beyond the next six months. In other words these figures are likely to understate what might happen from 2020-21 and onwards.

Instead the Government talks about the 'other side' and a return to normalcy as if that is a foregone conclusion. For example the Prime Minister, Scott Morrison, has said 'One of the important principles that we have put in place is to ensure that the [stimulus] measures are temporary and they do not provide long tails of expenditure' (Cranston 2020). Instead we are likely to need continued stimulus involving more deficit spending and further debt. We have to be prepared for that and so this paper presents the analysis to show why we should not fear the likelihood of further debt.

Not all of the additional spending shown in Table 1 need result in additional deficits and debt. The figure for the JobSeeker payment was \$14,133 million (Australian Government 2020). That was announced before the JobKeeper payment was decided which means the JobSeeker payments are likely to be overestimated by a fair amount. There are also doubts about the JobKeeper figures as well. The assumptions behind the estimated spending are that employers will apply with respect to 6 million workers which is 46 per cent of the 13 million employed at March 2020 (ABS 2020). We think the numbers involved will be substantially smaller than that. As of 27 April 540,000 businesses enrolled for JobKeeper in respect of 3.3 million workers (Djurdjevic 2020). We do not know how many will actually receive the payment.

The JobKeeper payment is likely to be very large under any scenario but lower than the government expected. Moreover the JobKeeper payment is taxable. Treasury estimates that the JobKeeper payment will reduce unemployment by 5 per cent (Frydenberg 2020) which amounts to about 687,000 workers (ABS 2020). These people will get a taxable JobKeeper payment rather than, at best a tax-free JobSeeker payment. A lot of the JobKeeper payment will go to businesses who would have otherwise retained their workers. By subsidising their workforce, those businesses will experience increased cash flow. Compared with what might have been, those businesses are likely to experience increased taxable income.

For these reasons the total impact on the deficit and debt should be much smaller than the figures for the expenses alone would indicate. Compared with what might have been the impact on the deficit and debt, it will be much less than the almost \$200 million in spending summarised in Table 1. It also goes without saying that the monetary policy initiatives will have no direct impacts on the deficit or debt.

Money is cheap

Official interest rates are at record lows and governments around the world have taken advantage of that. US Treasury Secretary Steven Mnuchin said that the government must spend freely to help workers and businesses hurt by official shutdown edicts. He told reporters: 'Interest rates are incredibly low, so there's very little cost of borrowing this money...In different times, we'll fix the deficit. This is not the time to worry about it' (Lynch 2020).

The Governor of the Reserve Bank of Australia, Philip Lowe told Four Corners:

We shouldn't be worried [about the debt]. It's the right thing to do... we have the capacity to borrow, our interest rates are as low as they've ever been, the Australian Government has a long record of responsible fiscal policy, so the budget accounts are in reasonable shape. And if ever there's a time to borrow, now is it' (Speers 2020).

There is, however, a gentle reminder to either side of politics who think they can avoid tough decisions in the future about this debt.

Well-known commentator, Chris Richardson, Partner, Deloitte Access Economics, is reported as saying

Does that mean we've just sentenced younger Australians to a lifetime of higher taxes and sub-standard services? No, we haven't. Never in the 2000 years of recorded history of interest rates has it been cheaper for governments to borrow. The government's average remaining term of its debt is currently 7.4 years. Current yields on 7 and 8 year bonds are 0.57 per cent and 0.65 per cent respectively. Applying that cost of borrowing to \$310 billion worth of debt would mean annual interest payments of about \$1.8 billion (Cranston 2020) .

Economists expect an extra \$1.8 billion in annual interest payments based on the forecast \$310 billion in new debt it will need to cover the costs of COVID-19 measures (Cranston 2020).

The Financial Review's own estimates suggest the low interest rates will save the government \$1.5 billion on refinancing older, more expensive borrowings over the next year, leaving it only \$300 million worse off in interest costs (Cranston 2020).

Before leaving this section it is worth reflecting on the older argument that government debt and deficits would 'crowd out' private spending. Crowding out refers to higher government spending leading to lower private spending on investment in particular but also some consumption goods. The intermediate variable was the level of interest rates and it

was assumed that higher government debt and deficits would put upward pressure on financial markets and so raise interest rates which in turn would make some private spending less viable. However, government deficits and debts around the world are now at record highs compared with the last several decades yet there is no evidence of the crowding out mechanism at work.¹

¹ Indeed, government investments in infrastructure and services which improve private sector productivity suggest the opposite – the so-called ‘crowding in’ effect.

Does debt have to be repaid?

BHP was established as a syndicate of seven people who agreed to contribute one pound sterling a week. It was later floated in 1855 with a paid up capital of £18,000 (BHP 1985). Some 135 years later and despite a history of massive profits it now has debt of US\$49.0 billion or \$76 billion in Australian dollars (BHP 2019). Clearly BHP has seen good reason to go into debt and virtually any substantial company is found to have some debt when their balance sheets are inspected. Incurring debt seems natural in the corporate sector but that is far from the lesson people want to draw for the public sector.

It is not just BHP: perhaps the majority of Australian households have gone into debt in order to purchase the family home. Perhaps none of those households likes debt but their actions suggest they feel better off borrowing in order to finance their housing.

By the end of this paper the reader will appreciate that there are many reasons not to fear debt but there persists the idea that it has to be repaid. There certainly does not appear to be an analogous view in the private sector. But note first as Mike Keating, former head of the Department of Prime Minister and Cabinet, points out,

the amount of debt might have been much greater if the Government had not taken action to limit the spread of the Covid-19 virus and to maintain the capability of the economy during the lockdown. A longer recession, where no action was taken to subsidise the continuation of employment and business capability, would have risked a bigger economic downturn and even more debt accumulating (Keating 2020).

Another way of considering this issue is that government debt is also a financial asset in the hands of those who are looking for a vehicle in which to hold their savings. People hold government bonds or securities (the main class of government debt) either directly or indirectly.

People do not necessarily want to run their assets down and certainly not on average. So when an asset matures and their outlay is repaid it is almost certain that the owners of those assets will be looking for new assets to park their savings. It is important to note that while one person can run down their savings by consuming more than they receive, not everyone can do that. In the economy as a whole spending must equal receipts. One person's sale is another person's purchase. If you spend more than you receive it means the rest of the economy must be receiving more than they spend. So people cannot run down the total stock of financial assets which means that if a government bond does mature people will want to replace it, either with something the same or similar. That is the first

point, as a whole people do not necessarily want to run down their financial assets and in aggregate they cannot.²

There is another more critical point when we ask what really happens when a government security matures. The government debt is extinguished and in return you receive a payment from the government for the principal value of the security. But in reality you have exchanged one form of government debt for money which is a liability of the Reserve Bank of Australia (RBA). That means total liabilities of the government are unchanged. Indeed, the government may well decide there is too much liquidity (cash and cash-like assets) in the system and sell more bonds to mop up the liquidity. The effect of that is to roll over the debt.

In the next section we go into further detail about how money and government debt interact. However, the main point of this section is that government debt does not have to be repaid and if it is repaid it merely involves replacing one form of government debt with another.

² This point is taken up in more detail in Richardson (2015). But note that here we are not considering other things such as bankruptcy which may well destroy some financial assets and so reduce the value of financial assets held in the community.

Where is the money going to come from?

We saw in the previous section the Commonwealth Government initiatives will involve increases in the government deficit worth some \$200 billion over this year and into 2020-21. People who may have been conditioned to fear words like ‘debt’ and ‘deficit’ have asked questions like ‘where is the money coming from?’

The government is constantly spending money, receiving money (such as taxes), selling government debt (through government security sales) and buying government debt (mainly on maturity). But the logical sequence is that the government engages in deficit spending and then may sell bonds to cover the spending. To illustrate this, we will go through these steps in more detail.

Before we start, we should point out some important institutional features of the Australian financial system: both the Commonwealth Government and the banks have accounts with the RBA. In the case of the Commonwealth Government, spending and taxing, and buying and selling debt, generally takes place using the Commonwealth’s account with the RBA.

Suppose the government decides to increase its expenditure by hiring you to do a media campaign. At the end of the first fortnight, you get paid \$2,000. That payment just appears in your bank account and your wealth is now higher by \$2,000.³

Looking at the other side of the transaction, the government makes that payment by drawing down its account with the RBA. After the payment to you, the government’s assets have reduced by \$2,000 or it has increased its overdraft/loan by \$2,000. Meantime your bank has a new liability of \$2,000: your deposit with the bank. But matching that bank’s new liability is additional assets of \$2,000 on the part of the bank, the equivalent of what the government paid you. That new \$2,000 asset on the part of the bank is likely to be an additional credit item in the bank’s balance with the RBA. The government effectively tells the RBA to take \$2,000 out of the government’s account and put it into the private bank’s account.⁴

By having the money paid into your bank account, your bank now owes you \$2,000 which you can withdraw at any time, and your bank has a new deposit of \$2,000 with the RBA. That new \$2,000 claim against the RBA is as good as money, which is why the press often

³ We keep it simple by ignoring things like superannuation and taxes that might be withheld.

⁴ In practice, your bank “takes” your money and gives you an equivalent credit item in your bank account; matching the new bank liability to you is a credit item in the bank’s account with the RBA.

uses the expression 'printing money'. However, the transaction just involves some instructions between computers rather than the physical printing of actual money.

You may want to leave things like that: the additional \$2,000 just sitting in your bank account. Or, you may want to spend some of that money on food, rent, petrol and various other things. Let's suppose that pretty soon you have spent \$1,900 and keep \$100 in the bank. You have used your transaction card so that now your deposit with the bank falls by \$1,900 to \$100. The bank's liability to you falls by \$1,900 as it has to honour your spending by reducing its credit with the RBA by \$1,900 as it pays into the accounts of your butcher, landlord and the others from whom you make your purchases.

As you spent that \$1,900, it became new deposits on the part of other people and the rest of the banking system has new deposits of \$1,900 and so new bank liabilities worth \$1,900. Everyone with whom you made purchases has new money in their accounts just like you initially did when you received payment from the government. Now as the butcher receives payment in exchange for your purchase, she may increase her spending elsewhere. In fact, the whole process continues until people hold new savings of \$2,000 that they do not wish to spend. Once things come to rest people will be happy to have new savings of \$2,000.

Notice what has happened.

- First, the banking system as a whole holds additional liquid assets equal to the original \$2,000.
- Second, that initial spending of \$2,000 has generated a further round of spending and generates new incomes worth a multiple of the initial \$2,000.
- The government went into deficit of \$2,000 and has lower deposits/higher debt with the RBA.

We are now left with the private sector holding an additional \$2,000 in liquid assets. It is important to note that the private sector now has an additional wealth holding of \$2,000. Most of that will be in the hands of the banks. Suppose now the government wants to 'finance the deficit spending' and soak up the additional liquidity in the system by selling government bonds worth \$2,000.⁵ The government issues more bonds and sells them through the regular auctions held by the Office of Financial Management.

It may be that the banks are looking to invest their surplus funds and so use their \$2,000 in assets to buy government bonds. It may be that the people who have some of that \$2,000 as savings in the banking system would prefer to hold some of it in government bonds either

⁵ It need not do this. The government may be quite content to see that \$2,000 remain as liquid assets in the banking system.

directly or through their superannuation funds. To keep things simple, we will assume the banks decide to buy the government bonds.

As Westpac and others pay for their bonds, they will credit the government's RBA account with \$2,000 and buy the equivalent value of government bonds. The upshot is that the banks use up the additional assets of \$2,000 to buy \$2,000 in government bonds.

We started with you receiving \$2,000 on account of the work you did for the government. But it could have started with the government giving the money to a pensioner, a defence contractor, or a host of other things the government can do. We can make it as complicated as we like—you may have a deal that some of your income is paid directly to a super fund, or pays school fees for your children. The government may pay out of an account with a private bank. The butcher has to pay wages and buy more inventory and so on. But while we can make the examples as complicated as we like, they all show the same process: the additional flow of spending increases the value of financial assets that the community is happy to hold and those financial assets are equal to the government deficit over that period which in turn is equal to the increase in government debt over the same period. Initially the new financial assets are just in the form of additional deposits in people's bank accounts. It goes without saying that no one is forced to do anything. The people who end up holding the debt of the government, in cash or securities, do so voluntarily.

Back to where we started: people ask where the money will come from, well the answer is that the deficit spending itself created the additional money/liquidity in the system. If the government sells bonds and gets that money back it changes the composition of the wealth in the private sector but not the value of the wealth itself.

HOW DOES THIS COMPARE WITH TAX-FUNDED SPENDING?

It is useful to compare the above example of deficit spending with what happens when the government increases taxes to pay for the spending. Your share of the new taxes may be \$2,000 which you pay to the government. The government places that deposit with the RBA. Behind the scenes as it were the private bank clears that payment by paying the RBA \$2,000. At the end of that set of transactions the government has increased its deposit at the RBA by \$2,000, you have reduced your deposit at the bank by \$2,000 and the bank itself has reduced its liabilities to you by \$2,000 and reduced its own deposit with the RBA by \$2,000.

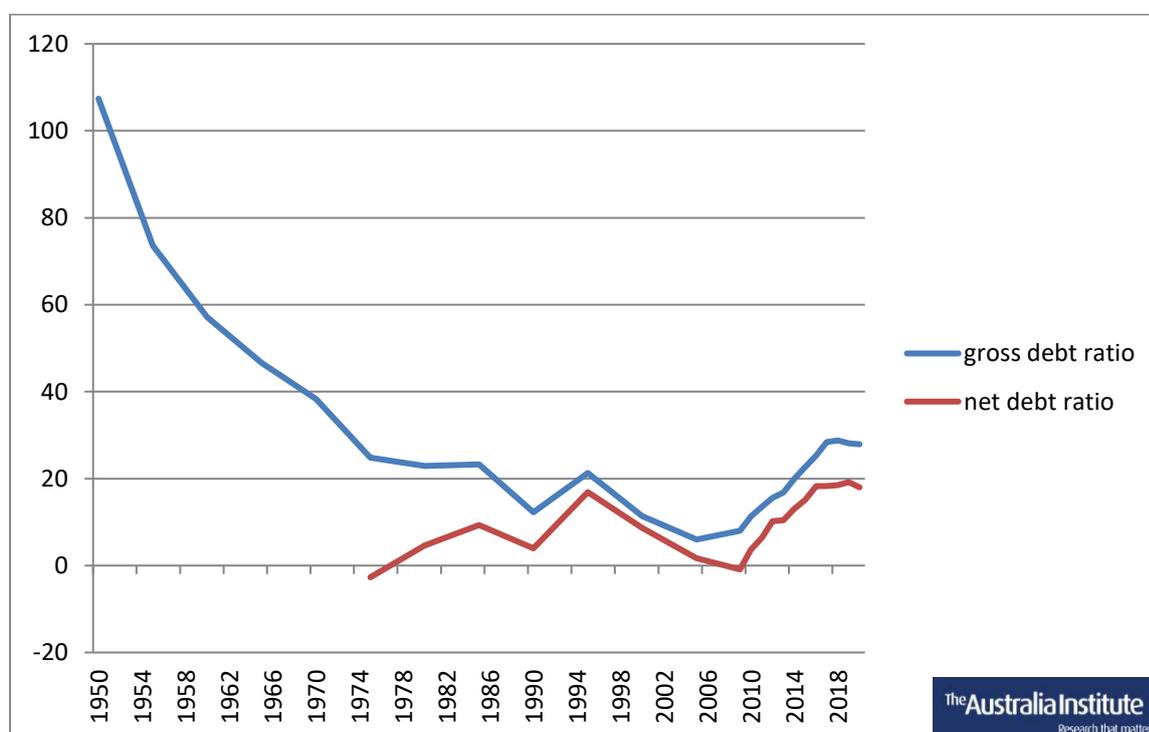
Now the government spends that \$2,000 and to keep it very simple we suppose once again it spends \$2,000 buying your services to run a media campaign. The government reduces its account with the RBA by \$2,000 and you again experience an increase of \$2,000 in your bank account.

Again the government purchase has taken place but no-one has experienced a net change in their wealth. Of course in a real world example the tax payers and the recipients of government payments will be different people. However, for the private sector as a whole there is no change in net wealth. By contrast, as we saw above, in the case of deficit spending the result is that the non-government sector experiences an increase in its wealth as a result of their increased holdings of government liabilities, whether those liabilities are cash, other RBA liabilities, government debt or a combination of all three.

Historical and overseas comparisons

In considering the level of government debt it is always instructive to compare Australia's position compared with its own history as well as the contemporary experience of other economies. For example, we can compare Commonwealth debt with the level of 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 28 per cent while the net debt ratio is 18 percent. Net debt⁶ figures are not available for the whole post-war period and the gross figures will overstate the net position somewhat.⁷ Nevertheless, the gross figures are interesting as they reveal that Australia's debt has fallen substantially over

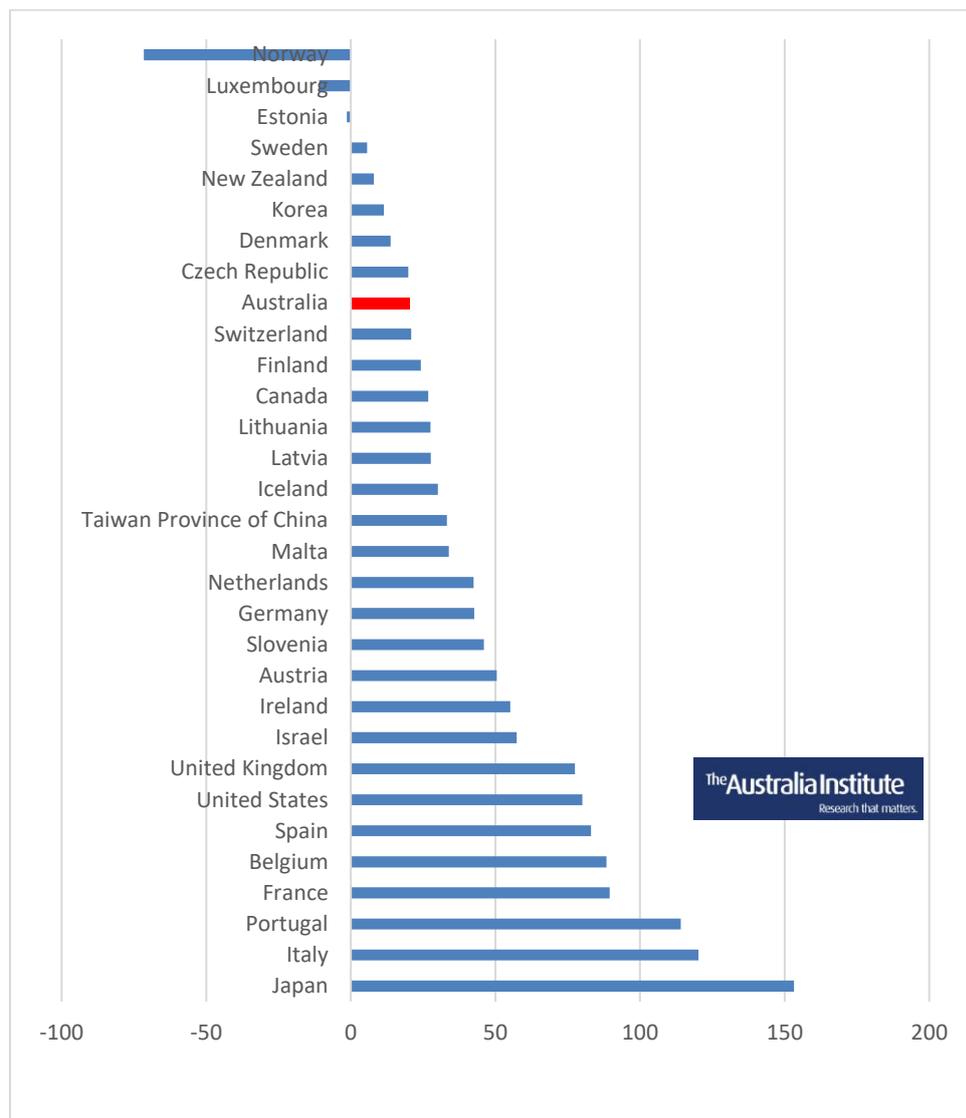
⁶ Net Commonwealth debt is gross debt less financial assets held by the Commonwealth.

⁷ 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 as well as any government debt held within the government sector.

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. Australia’s ratio is shown in red.

Figure 2: Advanced economies, debt ratios (%) 2019



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.

Mike Keating points out that there should also be no difficulty in financing this borrowing by the Australian Government. Similar to our point above, he notes the gross debt of all Australian Governments (State as well as Federal) only represented 41 per cent of GDP in 2019 – much less than in the UK (112 per cent) and the US (108 per cent), and an OECD average of 109%. Despite the usual misguided mumblings from the so-called ratings agencies, it might well be asked which other country than Australia will be more ‘credit worthy?’

Intergenerational equity?

If your thinking begins with the proposition that the government is just like a household, or a private company or some other private entity, then it is easy to end up in a muddle. As Keynes put it ‘starting with a mistake, a remorseless logician can end up in bedlam’ (Keynes 1931). Recently Lars (2019) has said:

Few issues in politics and economics are nowadays more discussed — and less understood — than public debt. Many raise their voices to urge for reducing the debt, but few explain why and in what way reducing the debt would be conducive to a better economy or a fairer society.

The assertions surrounding intergenerational issues is clearly a case in point with confusion coming from people and organisations who should know a lot better.

The issue of the intergenerational burden should have been put to bed years ago when Abba Lerner stressed that private debt and public debt are different in that private is external in that the debt is held outside the company. On the other hand public debt is held by the public and so is internal to the economic system. Hence he said:

A variant of the false analogy is the declaration that national debt puts an unfair burden on our children, who are thereby made to pay for our extravagances. Very few economists need to be reminded that if our children or grandchildren repay some of the national debt these payments will be made to our children or grandchildren and to nobody else. Taking them altogether they will no more be impoverished by making the repayments than they will be enriched by receiving them (Lerner 1948).

While that passage specifically refers to repayments of debt, exactly the same applies to servicing the debt.

Unfortunately that confusion of public and private debt continues seventy odd years later. The Australian Treasury and Department of Finance are not immune when they write up the budget papers. The budget papers 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. Abba Lerner (1961) in discussing the principle that the real burden of debt cannot be shifted to future generations and said ‘it is necessary for economists to keep

repeating this basic proposition because one of their main duties is to keep warning people against the fallacy of composition' (p 140).⁸

The message is 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).

Any notion that Government borrowing today imposes a 'burden' on future generations needs to be examined and upon closer examination, the notion breaks for the above reasons. Suppose there were a large amount of government debt on issue, perhaps \$1,000 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.

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.⁹ 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.¹⁰ 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, while the paper assets give rise to no additional net burden, physical assets that might be funded by government debt, like the Sydney Harbour Bridge, have made everyone better off.

⁸ The fallacy of composition involves generalising from the particular to the general and getting it wrong. Hence when I die my own children may bear the burden of my mortgage but for the community as a whole that debt will be balanced by the claims of the creditors.

⁹ 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 those who worry about debt seem to have in mind.

¹⁰ 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.

From an intergenerational perspective, the one bequest an earlier generation can genuinely make to future generations 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 limiting spending on infrastructure and other items thereby reduces the inheritance of the future generations.

The Blanchard thesis and other arguments

Former IMF Chief Economist Olivier Blanchard¹¹ has recently put the pragmatic 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 debt of \$560 billion.¹² 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 exploiting its good credit rating and access to cheap capital. In his view government can

¹¹ Oliver Blanchard is now a Senior Fellow at the Peterson Institute for International Economics.

¹² That is roughly the size of Australia's present GDP and gross government securities on issue.

finance long-term roads, rail and ports 'far more effectively'. He also said '[we] 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). Cameron Clyne 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. 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. The Blanchard and similar arguments also go to the question of whether debt is sustainable, a topic to which we now turn.

Sustainability

The word 'sustainability' is often bandied around but rarely is it clear what people have in mind. When you suggest something is unsustainable you strongly suggest that something is about to break with calamitous results. The same is no doubt true when people who should know better suggest debt is unsustainable. No doubt the intention is to suggest the country will end up in the equivalent of debtors' prison for countries. But people who know better do not even define 'sustainability' in this context nor do they outline any of the consequences. Elsewhere in this paper we have exposed some of the mistaken thinking and here we go to the question of whether indeed the level of debt can persist without the equivalent of debtors' prison.

If a particular level of debt is said to be unsustainable then presumably that means it cannot continue to exist at that level. There are lots of ways to approach this question. This concern is often expressed in terms of questioning the sustainability of large amounts government debt and occasionally that is generalised to include household and corporate debt.

We saw above that additional government debt cannot be considered context free. Debt comes about when the government spends more than it receives through taxation, fees, fines and other non-tax items. As we showed in the earlier section, 'Where does the money come from?' just the act of spending gives people a financial asset. No-one seems to refuse governments making deposits into their bank accounts. People may want to spend it or purchase an alternative financial asset but eventually a place is found for all the new government debt that is issued.

Aggregate savings

Saving involves the acquisition of financial assets and financial assets are the liability of other entities in the economic system. Putting it differently, those who save are lending to others who spend more than their income. Those who spend more than their income may be companies that borrow to invest or retirees who run down their savings in retirement. From a national perspective total borrowing has to equal to the total amount of savings.

The level of savings in Australia at the moment it is \$514 billion or 25.7 per cent of GDP.¹³ Put differently that means that the surplus of those who save is currently 25.7 per cent of national income which is equal to the deficit of those entities that borrow; the government and corporate sectors in particular. On the asset side, in 2019 the savings figures imply that savers have acquired new financial assets worth 25.7 per cent of GDP. Now just as savings is

¹³ Calculated from ABS (2020) 5206.0 by deducting total consumption from GDP for calendar year 2019; the four quarters to December 2019.

equal to investment plus other injections into the economy, those financial assets are equal to the liabilities of those who have borrowed.

Australia is of course a long way short of full employment. Suppose that the full-employment level of savings is \$600 billion. That is another way of saying that new investment and other injections worth \$600 billion will be needed to reach full employment. It is the new investment and other injections that also inject new financial assets into the economy. As the investor invests so more debt is created when using borrowed funds but it is also true when drawing down on the investors' own accounts. That means new deficits and new surpluses of some \$86 billion are required to reach full employment. We have to look at what that means for debt ratios.

Full employment debt to GDP ratio

Suppose the \$600 billion full employment savings is equal to 30 per cent of the full employment economy. From that we can estimate the full employment level of debt to GDP. All we need is the rate of growth in nominal GDP. Dividing the full employment rate of savings by the nominal rate of growth gives the asymptotic debt to GDP ratio:¹⁴ this is the value of debt to GDP to which we would be heading at full employment.¹⁵ We assume prices increase at the Reserve Bank's target rate of 2.5 per cent, productivity is running at 1.5 per cent and the labour force is growing at 1.9 per cent.¹⁶ That gives a growth rate of 5.5 per cent. Dividing the savings ratio by the growth rate gives 5.45 or 545 per cent of GDP which is the value of the debt to GDP ratio towards which Australia is heading.

We can see intuitively why the debt to GDP ratio has to be heading towards 545 per cent of GDP under the conditions just described. Let us assume debt to GDP is 1000 per cent of GDP or 10 times GDP which is 100. Now savings out of 100 is 30 while the increase in GDP in year 1 is 5.5. So we add 30 to debt and add 5.5 to GDP: the ratio of the two is of course 5.45 times or 545 per cent. Because we add 30 to debt and 5.5 to GDP we bring the original ratio down a bit to 1030/105.5 or 9.8 times. We can keep doing that and gradually we get closer to 5.45, the ratio of the savings rate to the growth rate.

We can go in the other direction. Let us start with debt to GDP at 2 times or 200 per cent. This time again savings increase debt by 30 and growth increases GDP by 5.5. The debt to GDP ratio now increases to 230/105.5 or 2.2. We can keep doing that and eventually we reach 5.45 again.

¹⁴ This is just a bit of high school maths but it will be given an intuitive explanation below.

¹⁵ For the mathematically inclined note that the debt to GDP ratio is equal to a constant of integration plus s/g where s is the savings ratio and g is the growth rate. The latter term is the asymptotic value.

¹⁶ The first two assumptions are also the official and implied official long run assumptions implicit in the Budget Papers. Over the last 20 years (to Mar 2020) the labour force grew at an average rate of 1.88 per cent (ABS 6202.0).

From these two arithmetical exercises we can see that if we start off at a different figure, the debt to GDP ratio soon moves back towards the ratio of the savings rate to the growth rate.

The important thing is that Australia is going to have a debt to GDP ratio of 5.45 when it is at full employment. It may be above or below but that is where it is heading. That means a large debt to GDP ratio is pretty well inevitable, assuming full employment is a policy goal. When business is at the centre of the economy we might expect that business investment is enough to absorb the nation's savings. But when that is not the case then full employment requires some other sector to go into deficit. Unless net exports happen to take up the slack then we hope the government will engage in deficit spending to fill that gap.

The other thing to note is that no matter what else is happening, the debt to GDP is heading inexorably towards the value of the savings ratio to the growth rate. There is no question that the value described is sustainable; it is not only sustainable but inevitable. However, the elements within the overall debt figure can include any combination of corporate debt, household debt, government debt, and foreign debt.

THE PARLIAMENTARY BUDGET OFFICE ON SUSTAINABILITY

The Parliamentary Budgetary Office (2019) has just published a report on net debt but it is really a plea for wider use of 'net financial worth' as a better indicator than net debt of what it calls 'fiscal sustainability'. They say 'net debt is widely regarded as a key budget indicator by which *fiscal sustainability* can be assessed' (emphasis added). However, they say that 'net financial worth', which is also published in the budget papers, is a broader measure of fiscal sustainability that includes all financial assets and liabilities. The PBO uses very guarded language of course but its main message is that rather than net debt we should be judging fiscal sustainability on the basis of net financial worth. Financial net worth just so happens to be negative and bigger than net debt so perhaps the implication is that we are less sustainable than first thought.

Fiscal sustainability is not defined. That is rather curious in a piece on sustainability and some discussion of what it is and how it applies might be relevant. Neither is there anything here to reflect the fact that private sector concepts are often meaningless in the public sector. The PBO insists net financial worth is a better measure of sustainability but we might ask does a negative net financial worth really affect sustainability and, by that, do we mean that the existence of the public sector is somehow threatened by outstanding debt or net financial worth (as the PBO prefers). A private company is of course completely different. If net worth is negative it is required to cease trading and wind up immediately.

On specifics, years ago The Australia Institute argued that notional amounts such as unfunded super liabilities should not be included in this sort of figuring (Richardson 2011) yet the PBO includes them. These are significant since including them makes Australia's negative net worth look almost twice as big at -\$488 billion (Australian Government 2019). If the unfunded super liabilities are to be included then we might ask why not include the value of such things as potential future tax revenue on the other side of the balance sheet? And indeed, why not include the unfunded value of the age pension into the distant future, veterans' entitlements, JobSeeker payments etc – all these are legislated entitlements too. The first National Commission of Audit (1996) gave the answer: unfunded super seemed reasonable to include because it was not too big, but unfunded future pensions might seem a bit silly and stretching the argument too far.

The evidence on economic growth

To this point in our discussion we have considered issues that may well have an impact on economic growth but we have not considered economic growth itself. Here we examine some of that evidence.

Early evidence was taken to show that high levels of government debt were associated with poorer economic performance, especially with regard to economic growth. A particularly influential paper by Reinhart and Rogoff (RR)(2010) purported to show that higher debt ratios were consistent with lower economic growth and that economies with debt ratios above 90 per cent experience an even greater reduction in economic growth. Indeed, above that figure economic growth disappeared according to their results. These results were repeated by many political figures to justify their own austerity policies (Cassidy 2013). Another group of researchers (Herndon et al 2014) tried to replicate the RR results. They could not replicate the results even using the same data sets. Instead they found a host of errors in the RR study. Their conclusion is that a review of RR's work finds:

that selective exclusion of available data, coding errors and inappropriate weighting of summary statistics lead to serious miscalculations that inaccurately represent the relationship between public debt and GDP growth (Herndon et al 2014 p.257).

These are particularly damning findings and were very embarrassing for RR. The results of Herndon et al suggest instead 'GDP growth when public debt levels exceed 90% of GDP are not dramatically different from when the public debt/GDP ratios are lower' (Herndon et al 2014 p 257).

Ash et al (2020) in a major study of the relationship between debt and growth reported that the study of 'the relationship between public debt and growth in advanced economies finds little evidence to suggest a substantial, causal negative relationship. We demonstrate that there is strong indication of a reverse causal relationship from GDP growth to public debt' (Ash et al 2020 p 25).

Moreover there is the suggestion 'that weak GDP growth probably causes higher public debt [through] reduced tax collection and increased public expenditure as well as the mechanical explanation of slow growth in the denominator of public debt/GDP' (Ash et al 2020 p 25). Their overall finding is 'that the effect of public debt on GDP growth is small and is zero in recent data. ... many policy decisions to confront public debt via austerity have hinged on the presumption of a threshold. There is no evidence of a public debt threshold above which growth is substantially reduced in any of the data, using any method' (Ash et al 2020 p 265).

Conclusions

Our main conclusion is that debt will not hurt us or our children or our grandchildren. The imposition of a burden on our children seems to be one of the main charges levelled at government debt. In reality some of our children will pay interest (via taxation) and others will receive interest on their ownership of the government debt. In exactly the same manner, some of our children will have deposits with the banking system and some will have mortgages and other debts to the banks. There may be debt within generations but there is no transfer of net debt across generations. The idea of leaving a burden suggests that after the present generation has gone, the next generation will be obliged to repay their dead forebears. The proposition is nonsense.

Against the deficit worriers we can also point out that government borrowing is dirt cheap at the moment, and our debt is at modest levels compared with our own historic experience and the experience of most other advanced economies. We also showed that comparisons with personal or business debt are illegitimate in the sense that the analogies quickly break down. Moreover, in a growing economy debt tends to wither away as the economy, tax revenue and other magnitudes are growing and outpace debt itself.

All the arguments against government debt and in favour of low levels of debt crumble away like sandcastles, especially in a country like Australia with its independent monetary and fiscal systems.

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