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Commonwealth Debt Management Review

This is a submission to the Commonwealth Debt Management Review, in response to the discussion paper: *Review of Commonwealth Government Securities Market* of October 2002.

Consistent with its purpose as a non-profit association dedicated to public education, research and policy analysis, the Evatt Foundation has had a longstanding interest in government policies on public debt, particularly with respect to the relationship between public debt and investment in public infrastructure. The Foundation has published many studies on this and related issues, beginning with *The Capital Funding of Public Enterprise* in Australia (Evatt Foundation: 1988) and including *Infrastructure, Superannuation and National Investment Strategy* (EPAC: 1995).

Accordingly, on 19 November 2002 the Foundation convened a public seminar on the issues raised by the Commonwealth's recent discussion paper, held in the Macquarie Room of the Southern Cross Hotel in Sydney. The seminar was addressed by:

Professor Frank Stilwell
Discipline of Political Economy
School of Economics and Political Science
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Associate Professor Tony Aspromourgos
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Mr John R. Rappell
Director, Policy and Marketing
Australian Financial Markets Association (AFMA)

Accompanying this covering letter are revised versions of the papers presented by Professor Stilwell and Associate Professor Aspromourgos. As you will appreciate, because he is a member of the Treasurer's Debt Review Reference Committee, Mr Rappell has had little opportunity to revise his paper for inclusion as part of this submission. He has, however, indicated that he hopes to complete this task after the AFMA submission has been forwarded, and we hope to forward his paper as a supplement at that stage.

Without limiting the substance of the accompanying papers, I highlight the following points:

- As is implicit in Professor Stilwell's paper in particular, the Foundation believes that the question of eliminating the Commonwealth government securities (CGS) market should be considered within the wider context of government policy in relation to the costs and benefits of debt in general and public debt in particular.

- The Commonwealth's discussion paper is seriously deficient in that it fails to consider the merits of public debt per se. As Professor Stilwell states "whether public borrowing is wise or unwise depends on the purposes for which the debt is used".

- Both Professor Stilwell and Associate Professor Aspromourgos have raised serious concerns about the validity of the economics represented in the Appendix to the discussion paper. While Associate Professor Aspromourgos accepts that there can be circumstances where public debt levels can influence interest rates, he points out that "there is not likely to be any smooth continuous functions linking debt and interest, as employed in the Appendix". Professor Stilwell also points out that evidence "to support the existence of any such 'crowding out' effect is inconclusive." Furthermore, he points out that there are circumstances in practice where "there is stronger evidence of 'crowding in' because government spending (for example, on building roads, schools or hospitals) creates additional investment opportunities for the private sector (for example, for road, school and hospital construction companies)".

- In any case, there is serious doubt about realising any macroeconomic benefits from further debt reduction. As Associate Professor Aspromourgos points out, with "Australian Commonwealth debt now so low relative to GDP, it's hard to imagine real benefits from going lower — other than political symbolism".

- As Professor Stilwell points out, given the lack of political support for higher taxes, reduced government borrowing implies lower capital expenditure, and "the deterioration in public infrastructure — in the quality of 'public goods' in general — is a direct consequence of the commitment to debt reduction". This point is supported by Associate Professor Aspromourgos, who notes that "the appropriateness of using more or less long-lived debt to finance capital expenditures is well understood and appreciated".

- More generally, as Associate professor Aspromourgos notes, many “issues could feed into a consideration of the costs and benefits of increasing the debt/GDP ratio”. And as Professor Stilwell states, “whether the interest constitutes a ‘burden’ depends upon how it compares with the social benefits arising from government spending”.

- Associate Professor Aspromourgos has set out the economics of sustainable public debt and its relationship to economic growth, interest rates and deficit budgets. As he concludes, “‘sustainable’ public budget balances are consistent with a spectrum of debt values of which zero is merely one special case”. Otherwise than in the case where a deliberate decision has been made that debt will be zero, it will only be in the case of the ‘fluke’ that the trend growth rate of the economy is equal to the average interest rate on public debt will the desirable long-run government deficit be equal to zero.

- Professor Stilwell considers that concerns about the relationship between foreign and public debt do not have a direct link. Associate Professor Aspromourgos accepts that low public debt may have counterbalancing effects, but suggests that this is “a complex matter” to which there can be no glib answer and, in any event, concludes “that it is extremely unlikely that the correct answer to what is the optimal value of debt will turn out to be the current Treasurer’s very ‘neat’ solution, zero.”

- Associate Professor Aspromourgos criticises the brevity with which the discussion paper considers the complex implications of the government’s zero debt policy for monetary policy, and suggests that “one would expect that as a matter of principle the RBA should make a submission to the Commonwealth Debt Management Review … and release its submission as a public statement of its views”.

- Both papers have suggested the possibility that the government’s policy in relation to public debt is driven by ideology or populist politics rather than the technical merits and the public interest.

I trust these papers will be useful in your deliberations. Should you wish any clarification or further information, the appropriate contact is Dr Christopher Sheil, School of History, University of NSW. Dr Sheil is a member of the Foundation’s Executive Committee and can be reached on (02) 9385 9252 (w) or 0419 43 6052 (m).

Your faithfully

Bruce Childs
President
6 December 2002

Different Dimensions of Debt

By Frank Stilwell

Politicians in this neoliberal era are wont to boast of their commitment to the reduction of debt. Peter Costello is now talking of zero debt for the Commonwealth government, thereby effectively eradicating the market for Australian government bonds. Meanwhile, other forms of debt – for housing and credit card purchases – are rising rapidly, apparently with the government's blessing. And the foreign debt continues to pump up the nation's current account deficit, widely regarded as a critical flaw in the performance of the national economy.

Many Australian people are understandably confused by all this. Is debt a problem or not? As a first step to sorting out the issues it is useful to distinguish the different dimensions of debt: personal debt, corporate debt, public debt and foreign debt.

Personal debt

Personal indebtedness typically arises when individuals spend on making purchases in advance of getting the income that would permit them to do so outright. Housing is the obvious example. Those who have not 'chosen their parents (or grandparents) wisely' nearly always need to obtain mortgage finance to purchase a home. The overall level of housing debt has climbed as house prices have escalated in recent years. Credit card debt is also escalating. The total personal debt in Australia now stands at $590 billion, rising by $22 billion in the 3 months to June 2002 – half of the increase being housing debt.

Whether incurring personal debt is wise depends on a variety of factors. Take the case of a carpenter or other tradesperson, borrowing money to buy good tools or a vehicle, for example. Those purchases enable the carpenter to earn income, to then pay off the interest and eventually, if work is plentiful, repay the principal. Debt in these circumstances is a sensible economic strategy. Indebtedness to finance one's education has a similar logic, as witnessed by the failure of HECS to deter most students from undertaking university study. As for housing debt, people need to make decisions about the relative advantages of rental and purchase, depending on their individual circumstances, interest rates and assessments of future housing price trends and expected future income streams. In other words, whether debt for these purposes is 'good' or 'bad' depends on complex judgements that properly vary from individual to individual.

In practice, the main social concern arising from personal debt is the interest rate burden, which is much higher for credit card debt than housing debt, of course. Going into debt to finance expenditures which have little prospect of generating income is particularly hazardous. Financing addictions to drugs or gambling in this manner is a major social problem. Having to borrow more to repay interest on past borrowings constitutes a disastrous outcome – a 'debt trap'.

Whether personal debt is wise or unwise for individuals, there is no doubt that it is central to the functioning of the economy. The buoyancy of the housing market depends on it. So, more generally, does the capitalist system as a whole. High and rising consumption spending is needed to absorb the economy's vast capacity to produce goods and services. The economic growth process is driven by commercial advertising and substantially financed by debt. It is a process that is enormously wasteful of resources and is not ecologically sustainable. This is the essence of modern capitalism. Peter Costello is not about to challenge that!

This is an era of rampant consumerism in which material aspirations are rising more rapidly than current incomes. It seems that (unlike *Sydney Morning Herald* commentator Ross Gittins) the people are not aware of the social-psychological evidence that more material possessions do not reliably create happiness! Personal debt has become an integral part of the spiral of want-satisfaction and want-creation, for better or worse.

Corporate debt

Debt incurred by Australian businesses is the second major category of debt. Somewhat similar considerations apply. For individual firms, going into debt may be quite sensible, but some significant macroeconomic consequences may follow.

Any proprietor wishing to expand his or her business more rapidly than is possible simply out of past profits must consider how to get the finance to do so. Equity finance is one option, but it is one that is often beyond the reach of small businesses for whom the issue of shares incurs too many administrative costs. Equity finance may also lead to a significant loss of the proprietor's control too, depending on whether shareholdings are dispersed or concentrated. Debt is the principal alternative. This may simply involve getting a loan from a bank or, for bigger businesses, the issue of corporate bonds. Such loan finance requires the commitment to make interest payments, whereas equity finance leaves the business with more flexibility about the level at which future dividend payments, if any, will be set.

So choosing between debt and equity finance is a matter of complex judgement. The balance between the two is known as 'gearing'. The gearing ratio (debt to equity) rose dramatically in Australia in the 1980's, which eventually made many businesses vulnerable because of their higher expenditure commitments as interest rates climbed towards the end of the decade. The gearing ratio levelled off in the 1990's but it generally rises with economic growth. It has a major impact on the demand for investment funds and can therefore affect the determinants of interest rates as well as the profitability of businesses. But Treasurer Costello is saying nothing about this either. In a capitalist economy, neoliberals generally adopt a *laissez faire* position on matters of corporate finance. The pervasive belief is that 'business knows best'.

Of course, whether businesses really do know what is best in practice is far from axiomatic. Sometimes the funds raised through loans (or equity) are unwisely used, even from a narrow profitability perspective. Where the emphasis is on using corporate debt to finance acquisitions, speculative ventures and other financial legerdemain, there may be no productive economic contribution at all.

From a social perspective, the question of ‘externalities’ also arises. The external effects of private investment decisions may be positive, as where debt finance leads to productive innovations of benefit to the national economy and society, including job creation and export success. On the other hand, externalities may be negative, as in situations where environmental degradation results. Corporate debt is not just a private matter: working people’s livelihood and the quality of life depend on how wisely or otherwise it is managed. To adapt the standard cliché (with a touch of irony), there can be no general presumption that ‘what is good for BHP-Billiton is good for Australia’.

Public Debt

The third debt item is government debt, and this is what is now in the spotlight. Peter Costello’s suggestion that it should be reduced to zero is the culmination of a decade of political rhetoric – and a corresponding practical commitment – to debt reduction. Public sector debt, by inference, is a burden on the nation. Indeed, it may be but, like personal and corporate debt, whether public borrowing is wise or unwise depends on the purposes for which the debt is used. There is an added social dimension too because of the essentially collective character of governmental expenditures, whether financed by debt or otherwise.

Governments can finance their expenditure either by taxes or by borrowing, and usually do so by a mixture of the two. The latter has more obvious logic when the form of expenditure involves capital investment, rather than spending on, say, social security payments. In other words, forms of expenditure which enhance the nation’s infrastructure, and from which future generations can benefit, are appropriately financed by public debt. That, at least, is the conventional wisdom which neoliberal ideology and practices challenge.

Of course, government borrowing involves a cost – the interest payments on government bonds, for example. That is usually said to be the main reason for seeking debt reduction. But whether the interest constitutes a ‘burden’ depends upon how it compares with the social benefits arising from the government spending. As in the case of the carpenter’s personal debt, the interest payments are not a net burden if the future income-generating capacity is enhanced.

A supplementary concern about public debt is the alleged ‘crowding out’ effect. Neoliberals say this arises because government borrowing competes with other corporate claimants on the relatively fixed pool of investment funds, thereby driving up interest rates, which leads to less private sector investment. Evidence to support the existence of any such ‘crowding out’ effect is inconclusive. In practice, there is stronger evidence of ‘crowding in’ because government spending (for example, on building roads, schools or hospitals) creates additional investment opportunities for the private sector (for example, for road, school or hospital construction companies).

So, as with personal and corporate debt, there are complex arguments about the ‘good’ and ‘bad’ aspects of public borrowing. The alternatives always need to be considered. Would financing public investment through higher taxes rather than debt be a better alternative? That option deserves serious consideration. However, it currently seems to have few supporters, as a result of the seemingly widespread belief that higher taxes are a political ‘no-no’. But if that option is eliminated, reduced government borrowing means lower capital expenditure. So the deterioration in public infrastructure – in the quality of ‘public goods’ in general – is a direct consequence of the commitment to debt reduction. Thus the ultimate ‘logic’ of the neoliberal program is the hollowing out of the public sphere of the economy and society.

Foreign debt

Foreign debt is different. It is a fourth category of debt that cuts across the other three. It is best regarded as a ‘slice’ through personal, corporate and government debt, rather than an additional type of debt. Thus, to the extent that borrowings by individuals, corporations and governments cause increased indebtedness to individuals, corporations and governments overseas, they add to foreign debt. The overseas borrowings are partly offset by Australian lending overseas, leaving a net foreign debt of currently about $330 billion, roughly equivalent to the total value of goods and services produced in Australia in half a year. The ratio of foreign debt to GDP in Australia is mid-range among the OECD nations. Most of the debt is corporate debt.

The Australian economy has always relied on capital inflow, whether through direct foreign investment or loans. Indeed, it is hard to imagine how the nation could have experienced the capitalist economic development that it has had otherwise. This is not to say that we should be relaxed about this being a permanent state of affairs. In the current era the nation would have the capacity to reduce dependence on capital inflow, if the vast pool of savings in superannuation funds were to be more effectively channelled into productive investment in Australian industry. The creation of a National Investment Fund for that purpose warrants serious consideration. Treasurer Costello will have no truck with any such ‘socialist’ policy, of course, and even the ALP seems hesitant to embrace it. But mobilising domestic savings for productive investment is the best way to reduce reliance on capital inflow. Meanwhile, over 20 per cent of the super funds continue to be invested overseas, making the need to rely on capital inflow correspondingly greater.

The main problem with foreign debt is the outflow of interest payments that an increased foreign debt generates. For the last two decades this outflow of ‘net income’ has been the biggest item in the nation’s current account deficit. To the extent that this current account deficit constrains the growth of the national economy, that is problematic. It is doubly problematic if it drives economic policy. It has commonly done so, leading governments trying to rein in the deficit to induce recession through their domestic fiscal and monetary policies. Such was the case with the notorious ‘recession we had to have’ a little over a decade ago. The current government seems to have no idea about how to cope with the situation. The so-called ‘twin deficits’ thesis, postulating a direct link between the government’s budget deficit and the current account deficit, has been discredited. A systematic interventionist industry policy seems politically out of the question. Control of capital flows has been deregulated. So the current account deficit is left to take its own course.

These macroeconomic matters are important consequences of foreign debt, notwithstanding some elements of arbitrariness in how national estimates of debt and deficits are made in an era when ‘globalisation’ undermines the coherence and integrity of ‘national economies’. But these concerns are largely independent of *public* debt. The foreign debt and the public debt are quite distinct matters, contrary to widespread misunderstanding. This is not to say that there cannot be a link – historically, the individual State governments have been significant contributors to foreign borrowings. However, the lion’s share of foreign debt in recent years has been associated with the corporate sector. It is the pattern of corporate borrowing, including the choice between domestic and foreign sources according to the prevailing market interest rates, that is crucial. Government policy regarding reductions in the overall level of public debt is not a major determinant of the outcomes, unless there is a direct and reliable connection between the size of public debt, the level of domestic interest rates and the propensity of corporations to borrow locally rather than from overseas.

Conclusion

Debt matters. It is multidimensional. Each dimension – personal, corporate, public and foreign – involves complex judgements about the desirability or otherwise of incurring particular forms of indebtedness, particularly focusing on the purposes for which the borrowed funds are used and what alternative sources of finance are available.

The different dimensions of debt are also interdependent. How wisely consumers and corporations make decisions about the levels and forms of their indebtedness has significant ramifications for government and its policies of public sector debt management. The capitalist system as a whole is permeated by debt and, as the stewards of the system, governments are necessarily central to its administration. The current government evidently sees no inconsistency in facilitating the growth of consumer debt while warning of the ‘burden’ of public debt.

From a collective societal viewpoint, judgements need to be made about the broader economic, social and environmental consequences of particular forms of debt-financed expenditures. To reduce all this complexity to a simplistic assertion of the inherent desirability of ‘zero public debt’ is laughable. Well, it would be laughable if it wasn’t so serious.

Is Zero Government Debt Desirable?

By Tony Aspromourgos

Introduction

This seminar addresses the fact that – due to a sequence of budget surpluses, but more importantly, actual and prospective privatisations – Commonwealth public debt could be extinguished in Australia in the next five years or so, and the current Treasurer would like to do that. It seems to me that there are five key issues raised by that possibility:

1. Is zero (federal government) public debt in any sense optimal? More particularly:
- Is zero public debt desirable *in principle*?
- Is zero public debt desirable in the *particular* Australian circumstances?

2. If the answer to the 2 questions under *1* (or at minimum, the second of these) is 'no', and Telstra is sold, are there alternative attractive Commonwealth asset or portfolio choices, rather than debt retirement? For example:
- Reducing unfunded Commonwealth superannuation liabilities, and/or repairing the natural environment?
- Or, in light of *1*, running (appropriately sized) budget deficits.
- Or even, not selling Telstra?

3. In the absence of a market for Commonwealth government securities (CGS), will the effectiveness of monetary policy implementation be compromised?

4. If the Australian government debt market did disappear, and government subsequently found it again had to begin issuing debt – which all previous modern history suggests is highly likely – will re-establishment of a market involve undesirable new start-up costs and difficulties?

5. Are CGS (held to maturity) a riskless or 'capital safe' asset (and over a large range of maturities), fulfilling a key role in many portfolios, and for which there are no adequate substitutes?

I may leave aside the last 2 questions, which will be addressed by another speaker – though with respect to issue *5*, it seems clear that in their own mind the authors of the Government's *Discussion Paper* are concerned about a vacuum occurring in the role of the CGS market in asset pricing and, via the derivative CGS futures market, in interest rate risk management (Commonwealth of Australia, 2002, pp. 35–49).

Zero debt is not generally optimal.

The *Discussion Paper* released by the Treasurer in October is a useful summary statement of the possible *consequences* flowing from extinguishment of government debt and closure of the associated market. But the deeper and prior issue is *whether* this should occur.

Consider the financial mathematics of 'sustainable' debt and deficits:

$$d = (g–i)D*$$

This simplified fundamental equation gives configurations of long-run or 'steady state' debt and deficit ratios – where d is the trend *primary* budget deficit as a percentage of GDP, $D*$ is the chosen trend in the ratio of pubic debt to GDP, g is the trend GDP growth rate of the economy, and i is the average interest rate on public debt.[1] To give it operational or intuitive significance, the equation can be read like this: given the trend growth rate of the economy (g), and given the trend in the interest rate paid on government debt (i), government can choose a desired trend in the ratio of debt to GDP ($D*$). This then determines the required trend in the primary budget balance, d.

But how is the choice of $D*$ made? Certainly if zero is the chosen value of $D*$ then clearly d must be zero – and of course the overall deficit will be zero as well. The overall deficit, as a percentage of GDP, is just:

$$d+iD* = (g–i)D*+iD* = gD*$$

Only under the fluke that $g = i$ will the desirable steady state value of d be zero, otherwise than in the case of $D* = 0$. And note that with $D*$ positive, and assuming trend positive g, *the overall public budget balance* ($gD*$) *is necessarily positive*. In a sense this is just an expression of the proposition that the private sector *needs* CGS: in a growing system there is then a growing demand for government securities, and the only way the supply can be augmented is by the government running an overall deficit.

But one must be careful in interpreting this logic in one respect in particular. This equation is about outcomes or configurations *along the steady state path* – or long-run trends, if one prefers. Hence, for example, if a government starts with a value of D it thinks too high, and wants to move to a lower value of D, then in the transition that government would have to run budget deficits smaller than steady state size, and possibly budget surpluses (and/or possibly sell assets). In other words, this fundamental equation describes *long-run* financial ratios not transition paths between *different values* of $D*$. The feasible values of $D*$ also will be conditioned by private sector portfolio preferences: what $D*$ are acceptable to the private sector, and on what terms. At the end of the day, in a market economy the public debt has to be willingly held by the private sector. But the key moral of this brief commentary really is this: **'sustainable' public budget balances are consistent with a spectrum of $D*$ values, of which zero is merely one special case**.

Is zero debt optimal in the *particular* case of Australia?

The essential issue in considering whether Australia in particular should have zero public debt is the trade-off between the benefits of increasing the trend value $D*$ (and therefore increasing the trend overall budget deficit, gD^*), and the costs of that. One cost might be a tighter primary budget balance, depending on the relationship between g and i. It may be noted also that higher D^* might feed back upon and raise i. The latter is determined by the economically relevant characteristics of the asset (CGS). These asset characteristics (or at least the market perception of them – e.g., heightened perception of exchange rate risk) might well change as D^* gets higher – though there are not likely to be any smooth continuous functions linking D and i, as employed in the Appendix to the government's *Discussion Paper*.

Many issues could feed into a consideration of the costs and benefits of increasing the debt/GDP ratio. For example, the appropriateness of using more or less long-lived debt to finance capital expenditures is well understood and appreciated. (What more long-lived assets to invest in via debt than repair of the Australian natural environment, to achieve a measure of environmental sustainability?) On the other hand – given the historic character of the Australian economy as a capital importer, and the associated high exposure to foreign liabilities – low public debt could be justified as a counterbalance to high private accumulation of foreign liabilities. In short, it is a complex matter, to which no glib answers need be given here. But it can be said, for sure, that it is extremely unlikely that the correct answer to what is the optimal value of D will turn out to be the current Treasurer's very 'neat' solution, zero. With Australian Commonwealth debt now so low relative to GDP, it's hard to imagine real benefits from going lower – other than political symbolism for the electoral advantage of the incumbent conservative government.

What about alternative asset accumulation, rather than debt elimination, if Telstra is sold?

In fact, from the point of view of 'rational portfolio choice', choice of its portfolio of assets and liabilities by the Commonwealth, Telstra should only be sold if there *are* more desirable assets for the Commonwealth to acquire, or liabilities for it to reduce. In a nutshell, *should* the government's portfolio be shifted to 'no Telstra' – and if so, *should* the new portfolio involve no debt, or should it rather involve other assets (e.g., assets to better balance superannuation liabilities of the Commonwealth, or enhancement of natural assets like Australian waterways)? Again, no pat answer need be provided here; but properly, it is with a view to the trade-offs between these possibilities that the matter should be deliberated upon. Certainly, to preserve debt and use Telstra sale proceeds to fund environmental public works would amount to saying, in a sense, that long-lived natural asset enhancement warrants long-lived public debt.

What are the implications for monetary policy?

The *Discussion Paper* is remarkably brief on the implications for monetary policy (pp. 54–6, 62). This is a technical question to which I would not proffer an emphatic answer. But one would expect that as a matter of principle the RBA *should* make a submission to the Commonwealth Debt Management Review, due by 6 December (p. 13), and publicly release its submission – as a public statement of its view concerning the implications for monetary policy (and perhaps also concerning the option of the Commonwealth acquiring an asset portfolio, since international experience, as outlined in the *Discussion Paper* Appendix, makes clear that the RBA likely would have a key role in the management or at least supervision of any such portfolio).

Conclusion

Might there be some politics involved? In conclusion, one may wonder whether this whole proposal of closing the debt market might not be just a kind of large-scale government publicity stunt, though others who are closer to the politics will be better able to judge. The debate around the issue has of course gained considerable (free) publicity for the government's debt reduction outcomes – outcomes which seem to be a positive for the government with 'average punters'. Or, in a somewhat similar vein, perhaps there is a measure of ambit claim in the proposal, with a Telstra sale eventually being used for a mix of debt reduction, environmental & other public asset rebuilding, and perhaps asset accumulation in support of Commonwealth unfunded superannuation liabilities. P. Costello, Treasurer, might be of sufficiently limited imagination to be attracted to leaving a 'monument' like zero debt; but P. Costello, PM, might be more alive to the electoral attractions of, for example, funding an environmental policy that would draw votes from RARA (rural and regional Australia) *and* preferences from Green voters – and so might J. Howard, PM, be so alive to those attractions, if he stays on.

Notes

[1] It is difficult briefly to provide an intuition of this equation, but consider this: starting at the desired debt ratio D^*, to keep that ratio constant debt must grow at the same rate as GDP. So, write an equation equalizing the growth of debt and GDP. Manipulating such an equation then produces the equation above. It should not surprise that this equation includes d, i and g: the first two determine the growth of debt; the third determines (in fact *is*) the growth of GDP. (The 'primary' budget deficit, by the way, refers to the budget deficit net of interest payments on government debt. The budget deficit as a whole, as a percentage of GDP, is $d+iD^*$.)