# FISCAL POLICY AND PUBLIC DEBT

WEBINAR PRESENTATION

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# What is ‘fiscal policy’?

- Fiscal policy is the use by governments of the revenue (taxation) and/or spending sides of their budgets in order to influence economic outcomes
  - these ‘economic outcomes’ can be either broad ‘macro-economic’ objectives such as economic growth, unemployment and inflation
  - or other objectives such as the distribution of income or wealth, the growth of specific sectors of the economy, or the development of specific regions
- The idea that governments *should* use their budgets to influence economic outcomes is often attributed to the work of the economist John Maynard Keynes (and in particular his 1936 book, *The General Theory of Employment, Interest and Money)*
  - although in practice his ideas had already been implemented by US President Franklin D Roosevelt in his ‘New Deal’
  - and had also been advocated in Australia by Edward (‘Red Ted’) Theodore who was Treasurer in the Scullin Labor Government in the early 1930s
- Some fiscal policy ‘happens’ without conscious government decisions
  - for example, personal and company income tax collections fall, and spending on unemployment benefits rises, when the economy slows – these are known as ‘*automatic stabilizers*’
- But the focus here is on ‘*discretionary*’ fiscal policy …
  - that is, conscious decisions by governments to cut taxes and/or increase spending in response to economic downturns (or, conversely, to raise taxes and/or cut spending in order to moderate ‘booms’)
- … and on the ‘stocks’ (of public debt) that result from the ‘flows’ (of budget deficits or surpluses) that result from fiscal policy decisions

# The rise, fall and rise of fiscal policy in Australia

- **Following the formal adoption of 'full employment' as 'the' (bi-partisan) objective of economic policy in Australia after the end of World War II, fiscal policy was the 'weapon of choice' of governments of both political persuasions in responding to economic fluctuations for more than 40 years**
  - for example, at the height of the 'wool boom' in 1951, the Menzies Government imposed a 10% surcharge on personal income tax, raised the company tax rate by 1 pc pt and the rate of wholesale sales tax from $8\frac{1}{3}\%$ to $12\frac{1}{2}\%$
  - in 1959, in response to a slowdown in the economy, the Government introduced a 5% rebate on personal income tax
  - in 1971 the Government imposed a 5% additional levy on personal income tax and raised a range of sales taxes
  - the 1982-83 (Fraser) and 1983-84 (Hawke) Budgets were consciously stimulatory, with the budget deficit increasing from 0.3% to 2.4% and then 3.8% of GDP, largely on account of increases in government spending of $7\frac{3}{4}\%$ and then $8\frac{1}{4}\%$ in real terms
- **The active use of fiscal policy fell out of favour during the second half of the 1980s, the 1990s and early 2000s**
  - partly because it was thought that fiscal policy was subject to very long lags which reduced its effectiveness
  - and partly because monetary policy was seen as being capable of being adjusted more quickly and with greater impact
  - fiscal policy instead focussed on seeking to achieve budget surpluses so as to "boost national saving" and thereby reduce Australia's 'chronic' (as they were seen) current account (external) deficits
- **Fiscal policy came back into focus during the global financial crisis**
  - largely because it was thought that monetary policy would be less effective given the damage the crisis did to banking systems, and the willingness to borrow or lend
  - as spelled out by Ken Henry the lesson learned from earlier episodes was "go early, go hard, go households"
- **And fiscal policy played an even greater role in the response to the recessions induced by Covid-19**
  - as it should have, given that those recessions were brought on by government actions (unlike almost all other recessions)
  - but also necessary given that interest rates had fallen to as low as they can practically go, limiting the scope for monetary policy to play much of a role

# How does fiscal policy work?

## In response to an economic downturn or recession

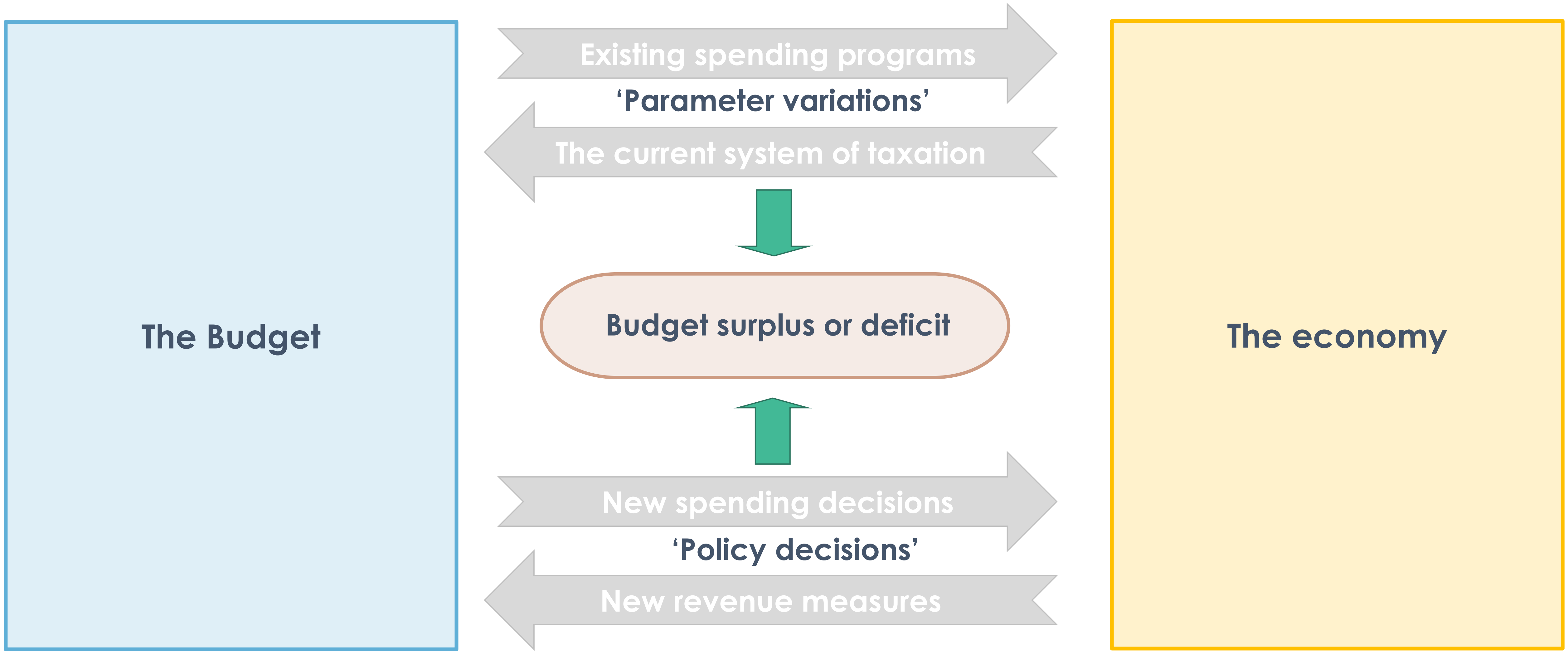
- Cutting taxes allows individuals or businesses to keep more of the income which they have earned
  - in the hope that they will then spend it in ways that boost economic activity and create jobs
- Tax cuts will be less effective to the extent that those who benefit from them save the additional income rather than spend it
  - since high income earners tend to have a higher 'propensity to save', tax cuts will usually be more effective in boosting economic activity and employment if they are directed towards lower-income earners (although the lowest income earners usually don't pay tax at all)
  - and at least some of the additional spending which might be prompted by tax cuts could be directed towards imports
- Increases in social security benefits, or cash grants to low-income households, are more likely to be spent, and thus be more effective in boosting economic activity and employment
- Direct government spending – for example on infrastructure, has an even stronger impact on economic activity
  - and can create something which yields long-run benefits
  - but can also take longer to put into effect
  - Increases in recurrent spending can be hard to unwind afterwards
- Explicitly time-limited tax cuts or cash grants can be more effective in encouraging people or businesses to 'bring forward' spending decisions

## In response to an economic boom

- Tax revenue tends to rise (as a share of GDP) automatically during booms (and spending on unemployment benefits tends to fall)
  - governments can be tempted to spend these windfall revenue gains (or 'give them back' in tax cuts), which can intensify the 'boom' (as happened in 2003-07)
- Raising taxes (or at least, not 'giving back' the revenue increases that naturally occur during booms) helps to dampen demand pressures that might otherwise lead to higher inflation
  - which in turn may reduce the need for increases in interest rates (to which the Australian economy is now much more sensitive because of the rise in household debt)
  - although the structure of Australia's personal income tax scales means that the burden of 'bracket creep' falls disproportionately on lower and middle-income earners
- While cutting government spending is difficult at any time, during booms, governments can at least avoid starting expensive new spending programs, and perhaps wind back on 'big ticket' infrastructure spending

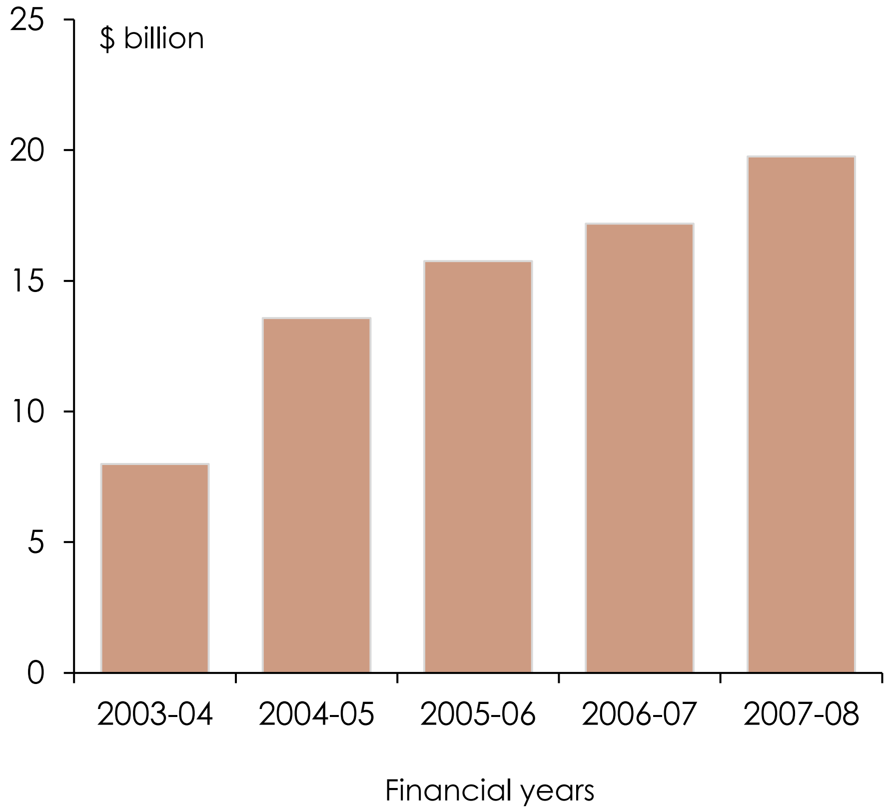
# The economy affects the state of the government’s budget – as well as the budget affecting the condition of the economy

## The two-way inter-actions between the Budget and the economy



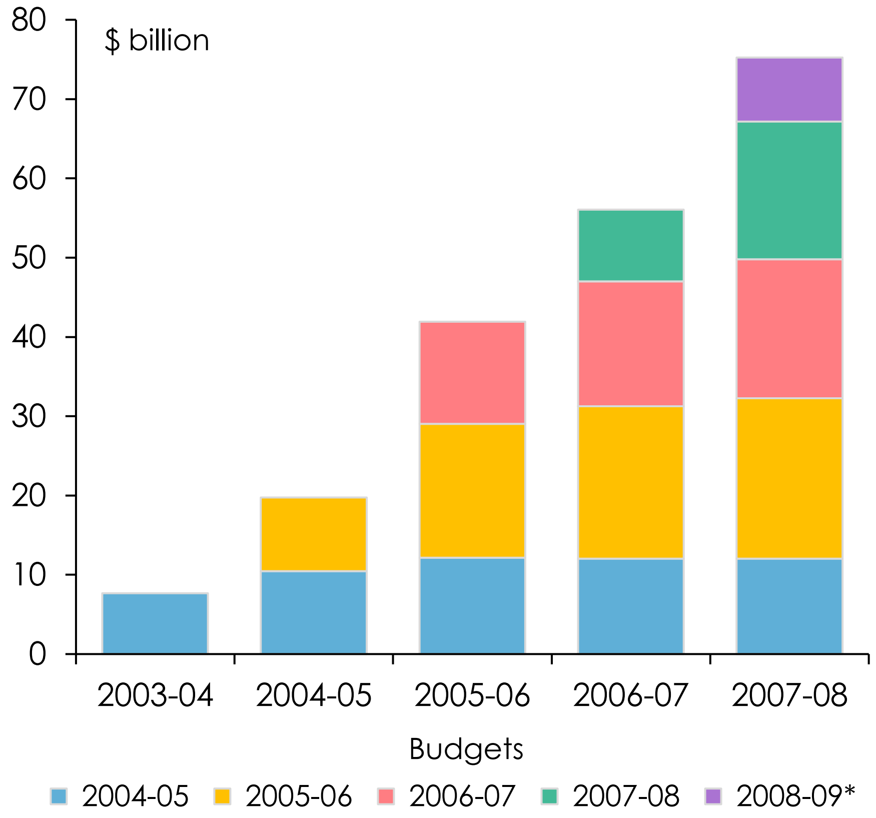
# Did rising budget surpluses during the years leading up to the global financial crisis mean that fiscal policy was 'tight'? No, not really

## Commonwealth Government 'underlying' cash balance



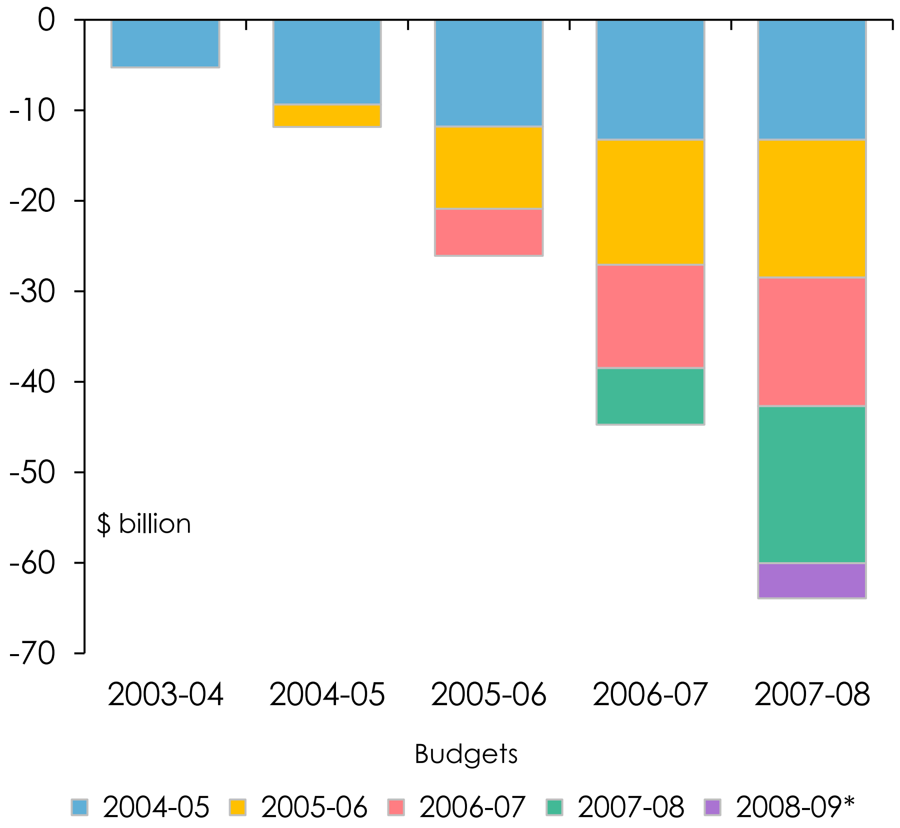

**The Howard Government ran larger budget surpluses every year from 2003-04 through 2007-08**

## Impact of 'parameter variations' on the 'underlying' cash balance




**Those surpluses were largely the result of revenue windfalls generated by sharply rising commodity prices and booming property & stock markets …**

## Impact of 'policy decisions' on the 'underlying' cash balance




**… which the Howard Government 'gave back' in the form of repeated large tax cuts and increases in cash benefits to families and pensioners**

*Note:* 'Parameter variations' refers to the estimated impact on the cash balance of changes in economic and other assumptions used in forecasting receipts and payments. Estimates for years beyond the four years shown in Budget and MYEFO papers are assumed to be unchanged from the last year shown in those papers (almost certainly a conservative assumption). 'Budgets' include the immediately preceding Mid-Year Economic & Fiscal Outlooks; 2008-09* refers only to the 2007-08 MYEFO.
*Sources:* Australian Government, Archive of Budgets, Budget Paper No. 1 and Mid-Year Economic and Fiscal Outlook (MYEFO), 2003-04 through 2007-08.



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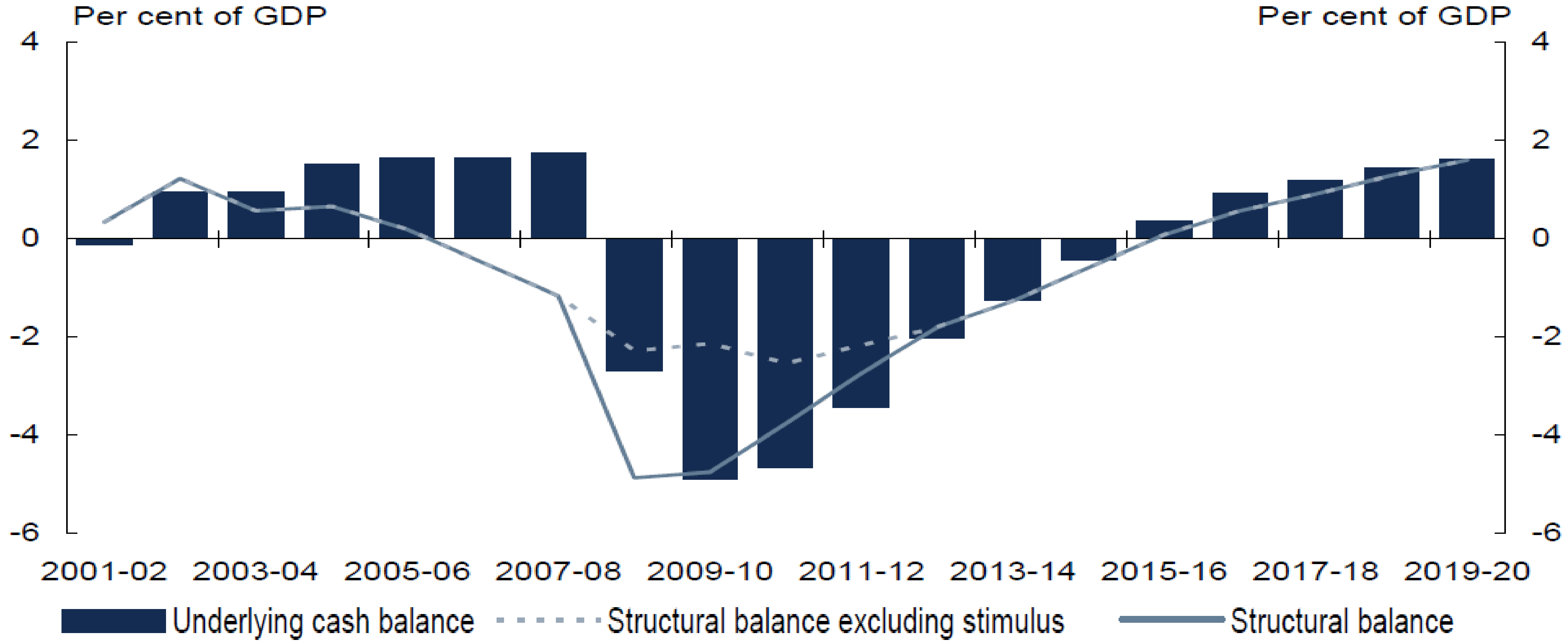
# What really matters is the so-called 'structural' budget balance (that is, abstracting from the impact of fluctuations in economic activity)

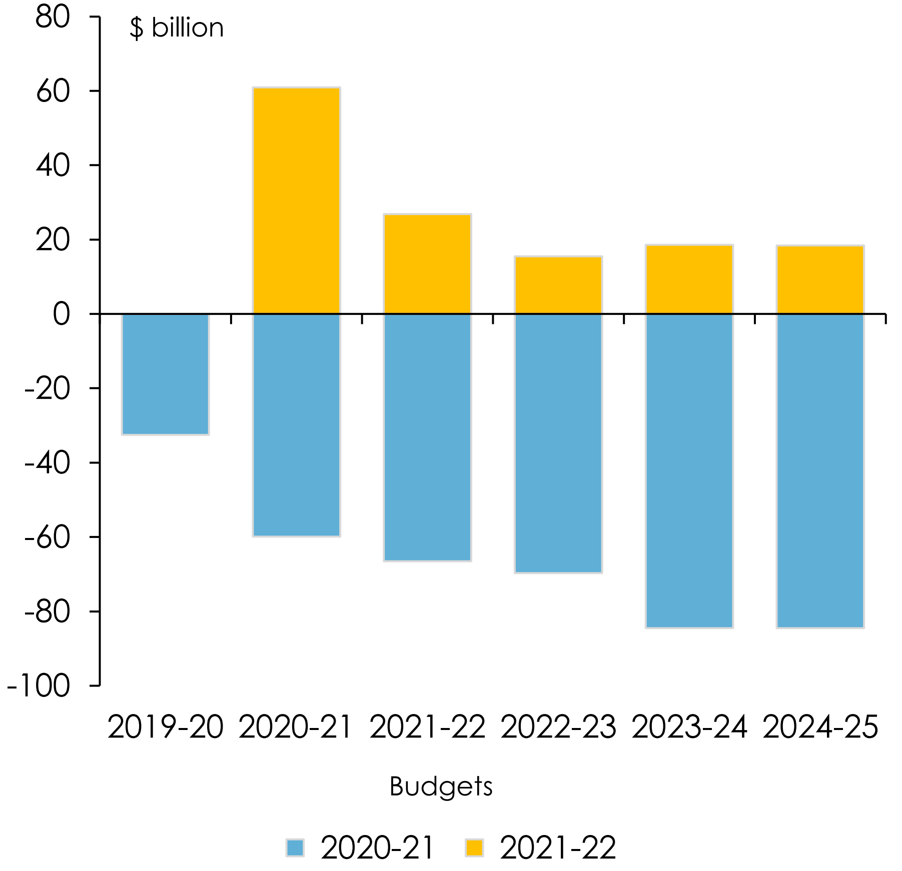
## Estimates of the 'structural' budget balance published in the 2009-10 Budget Papers



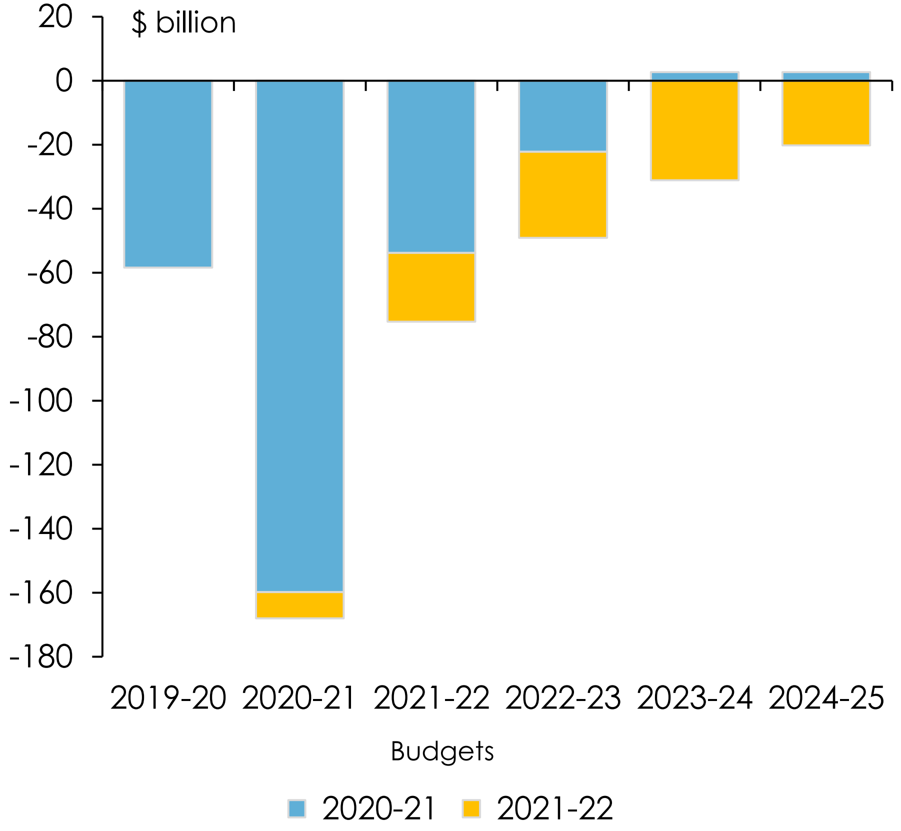

*Source:* Australian Government, 2009-10 Budget Paper No. 1 - Budget Strategy and Outlook, Statement 4, Chart 10.

# The 2020-21 and 2021-22 Federal Budgets have been unambiguously stimulatory (and rightly so)

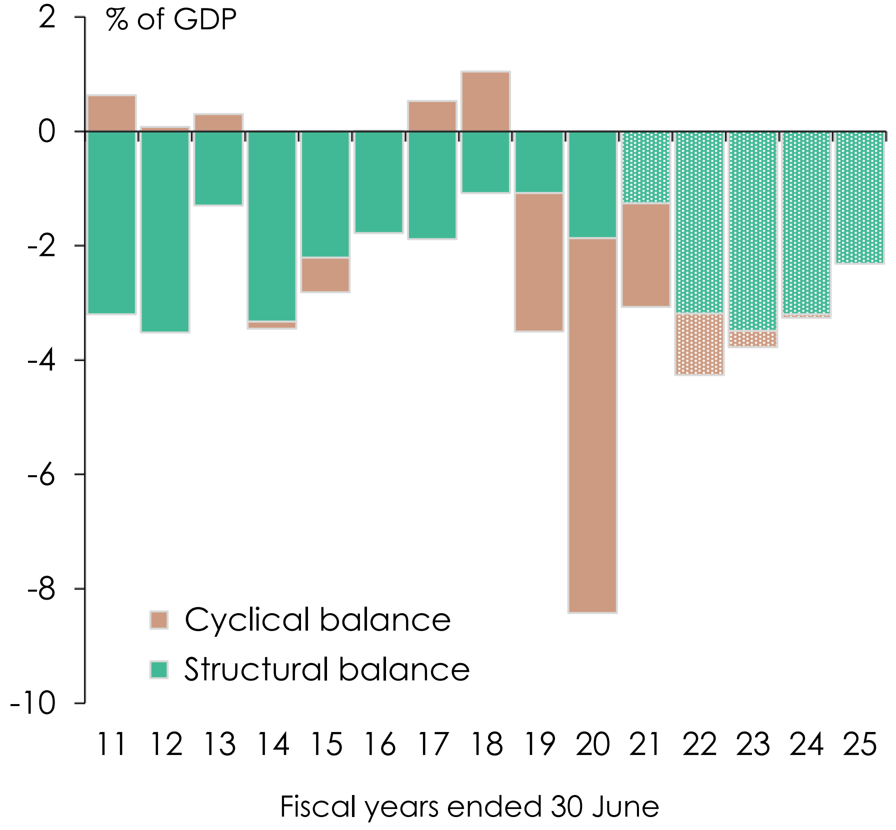
## Impact of ‘parameter variations’ on the ‘underlying’ cash balance




## Impact of ‘policy decisions’ on the ‘underlying’ cash balance




## ‘Structural’ and ‘cyclical’ components of the cash balance




**Last year’s recession would have resulted in large budget deficits even if the Government hadn’t done anything**

**… but, quite rightly, the Government made ‘policy decisions’ which made those budget deficits even larger**

**Although the deficit will shrink as the economy recovers, there will still be a large structural deficit**

*Sources:* Australian Government, 2020-21 Budget Paper No. 1 - Budget Strategy and Outlook - Statement 3 and 2021-22 Budget Paper No. 1 - Budget Strategy and Outlook - Statement 3, Table 3.4 and Chart 3.11.

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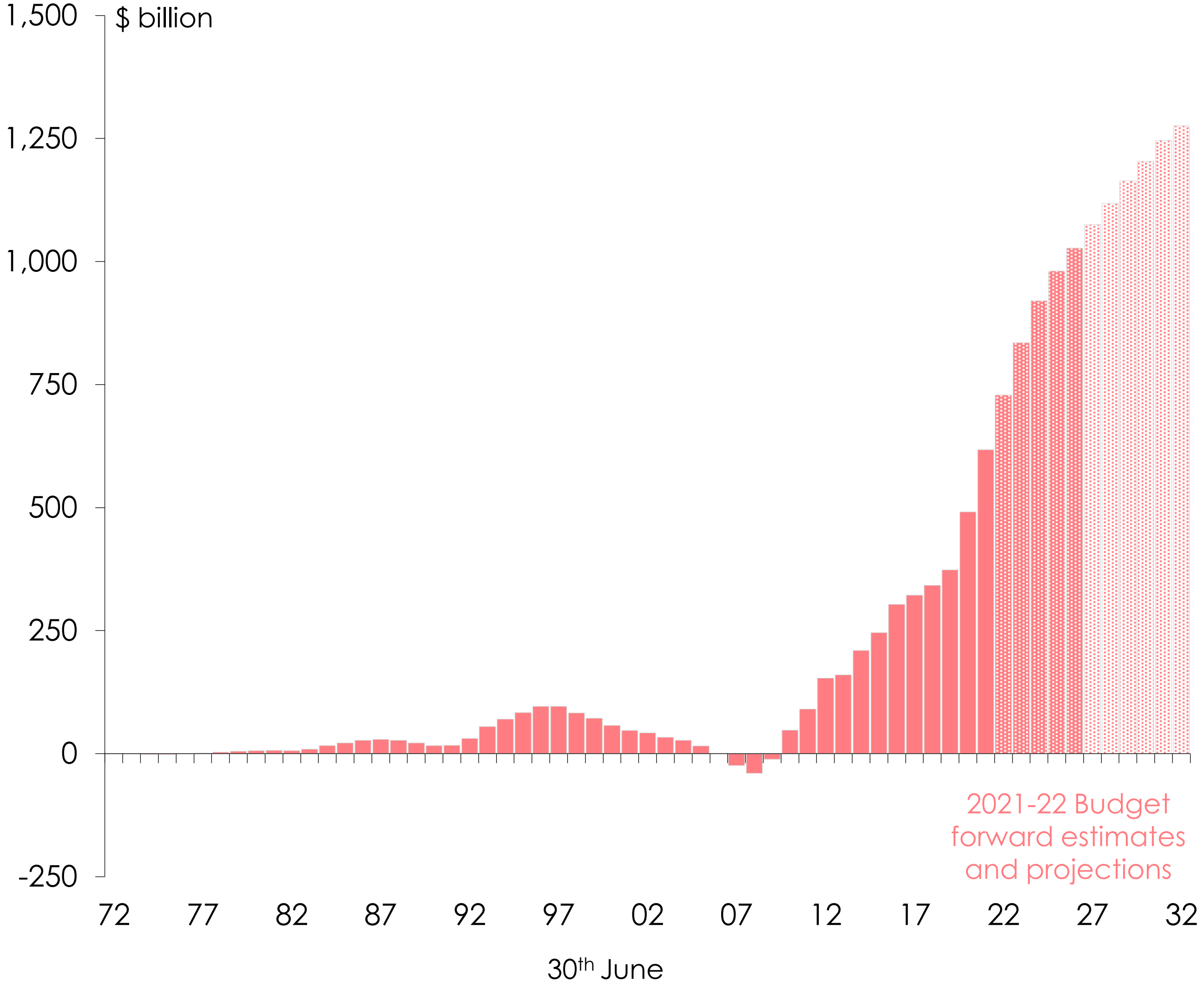
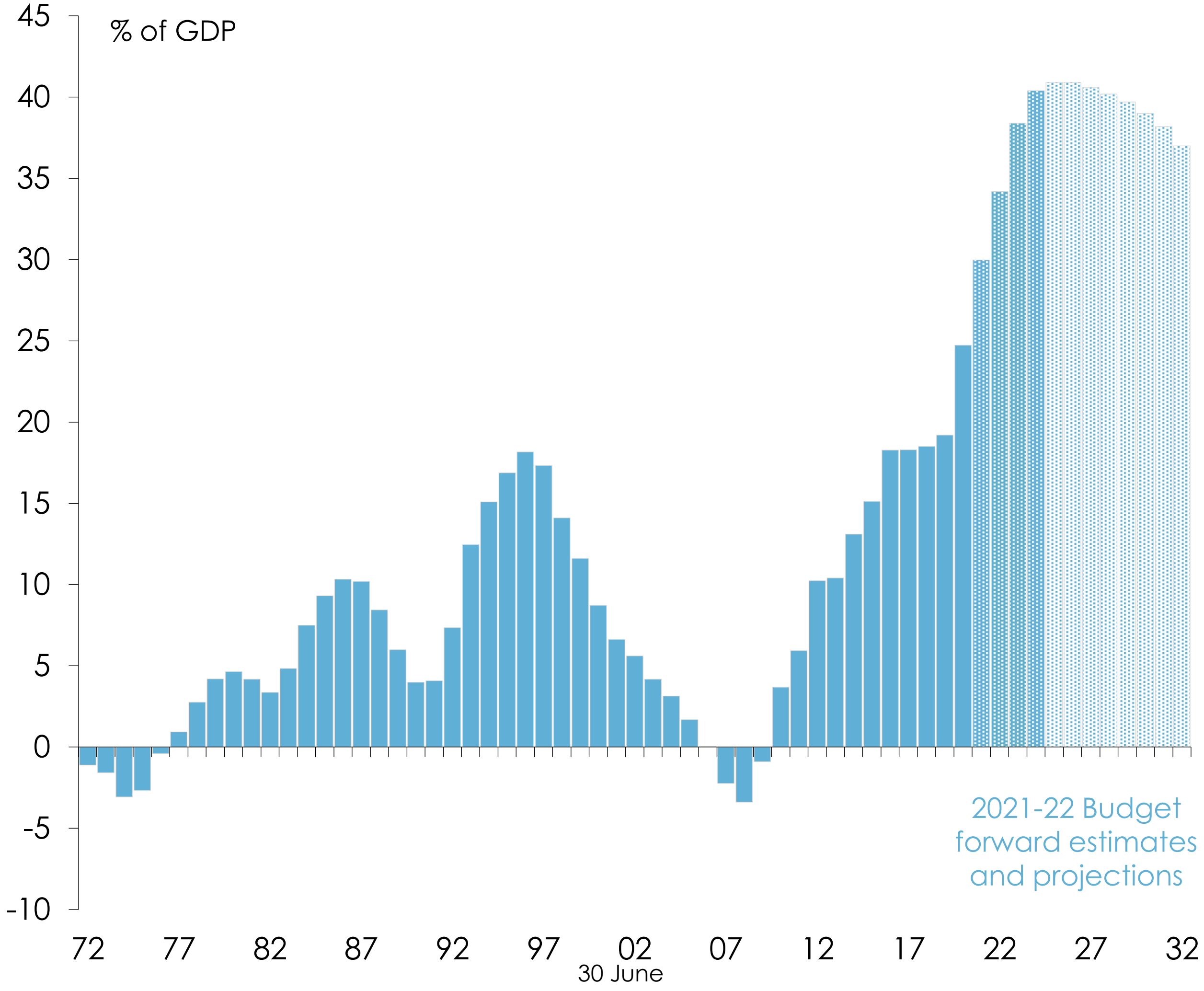
# Those ongoing large deficits will result in a significant increase in the Commonwealth Government's net debt

## Commonwealth Government net debt



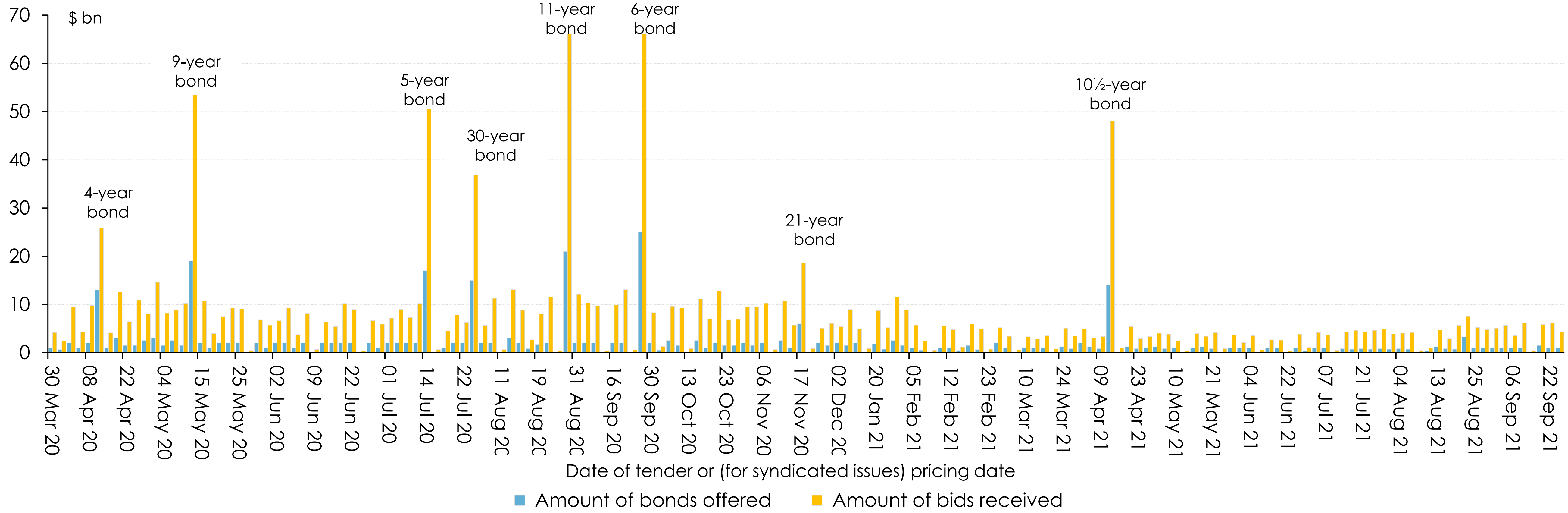

## Net debt as a percentage of GDP




*Note:* 'Net debt' is the interest-bearing liabilities (mainly government bonds) less the sum of selected financial assets (cash and deposits, advances paid and investments, loans and placements). *Source:* Australian Government, 2021-22 Budget Paper No. 1 - Budget Strategy and Outlook - Statement 11.

# The Commonwealth Government is having absolutely no difficulty financing its deficits – investors are eager to buy Australian bonds

## Commonwealth government bond issuance since March 2020




- Since 30th March 2020, the Australian Office of Financial Management has issued almost $321bn of Treasury bonds – based on the volume of bids received it could have borrowed more than $1.2 trn with yields at most 4 bp (0.04 of a pc point) above the highest yields actually accepted
- So far this financial year, the AOFM has received bids totalling more than $112bn for the $24bn of bonds it has offered for sale – a 'coverage ratio' of 4.7 times, cf. 3¾ times during the 2020-21 financial year

*Source:* Australian Office of Financial Management data hub.

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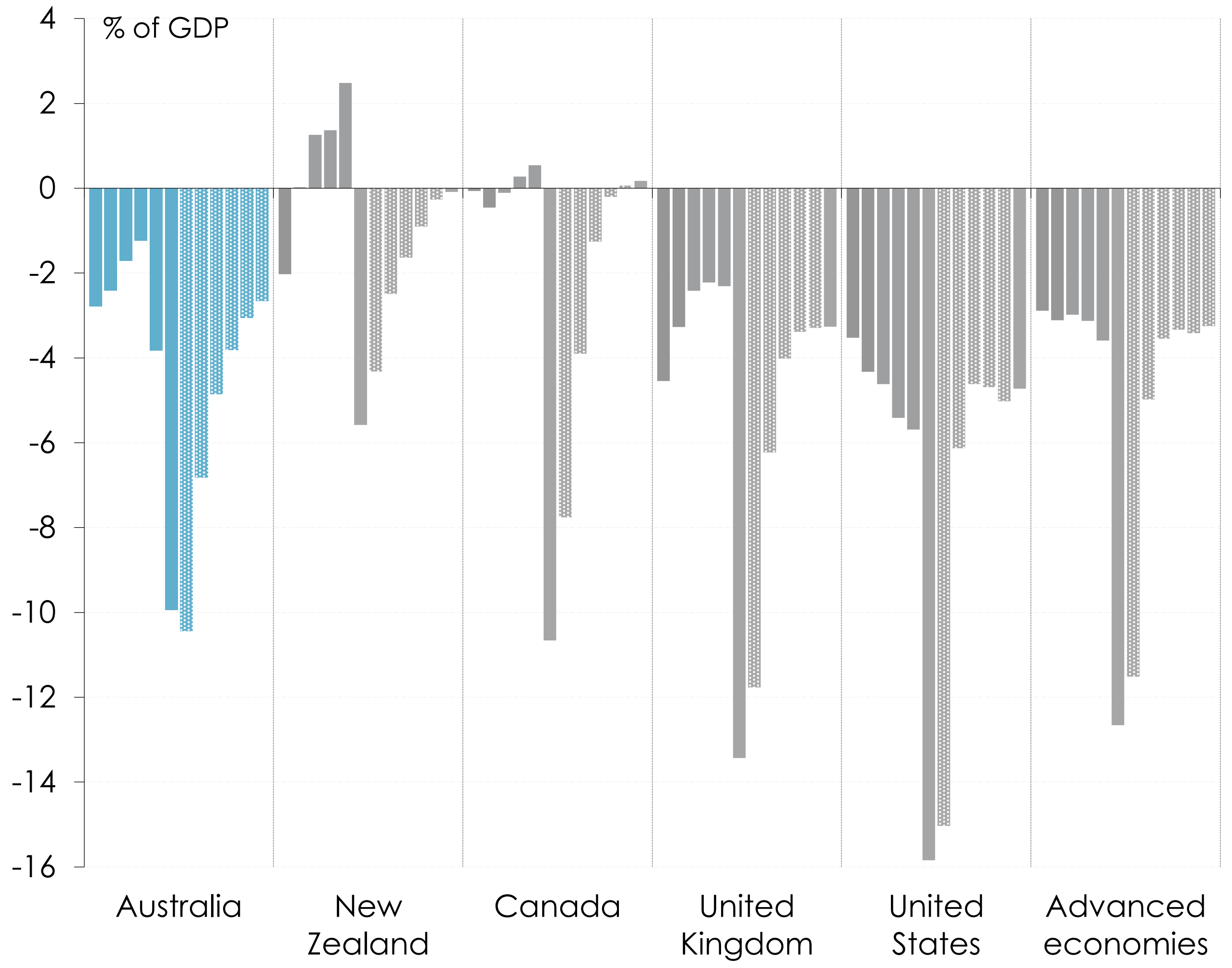
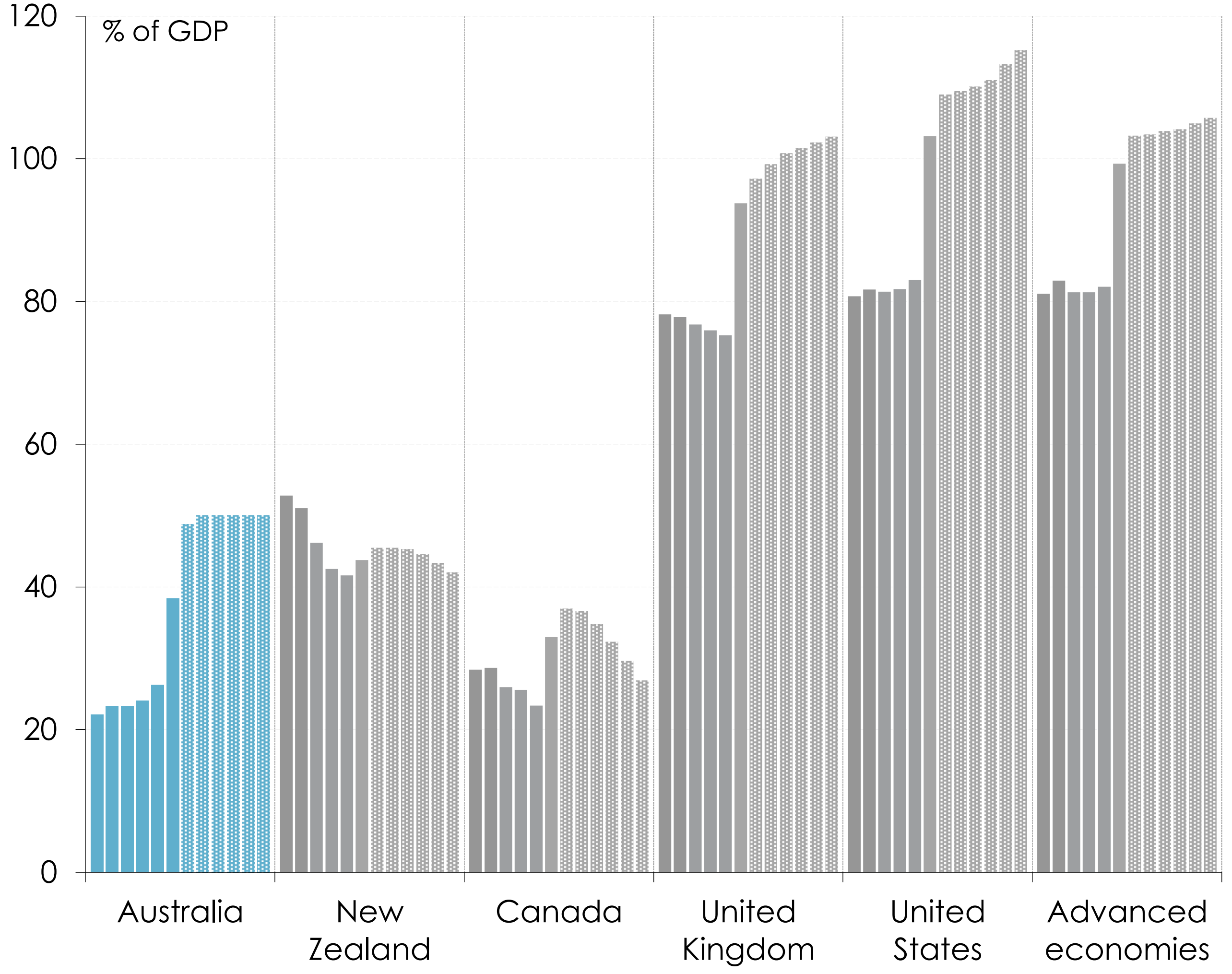
# Australia's public finances are in much better shape than those of most other comparable countries

## Australia's budget balances and government net debt vs other comparable 'advanced' economies

### Budget balances, 2015-26




### Net debt, 2015-26




*Note:* The data depicted in this chart include state (or provincial) and local governments (as well as national governments).
*Source:* International Monetary Fund, *Fiscal Monitor*, April 2021.

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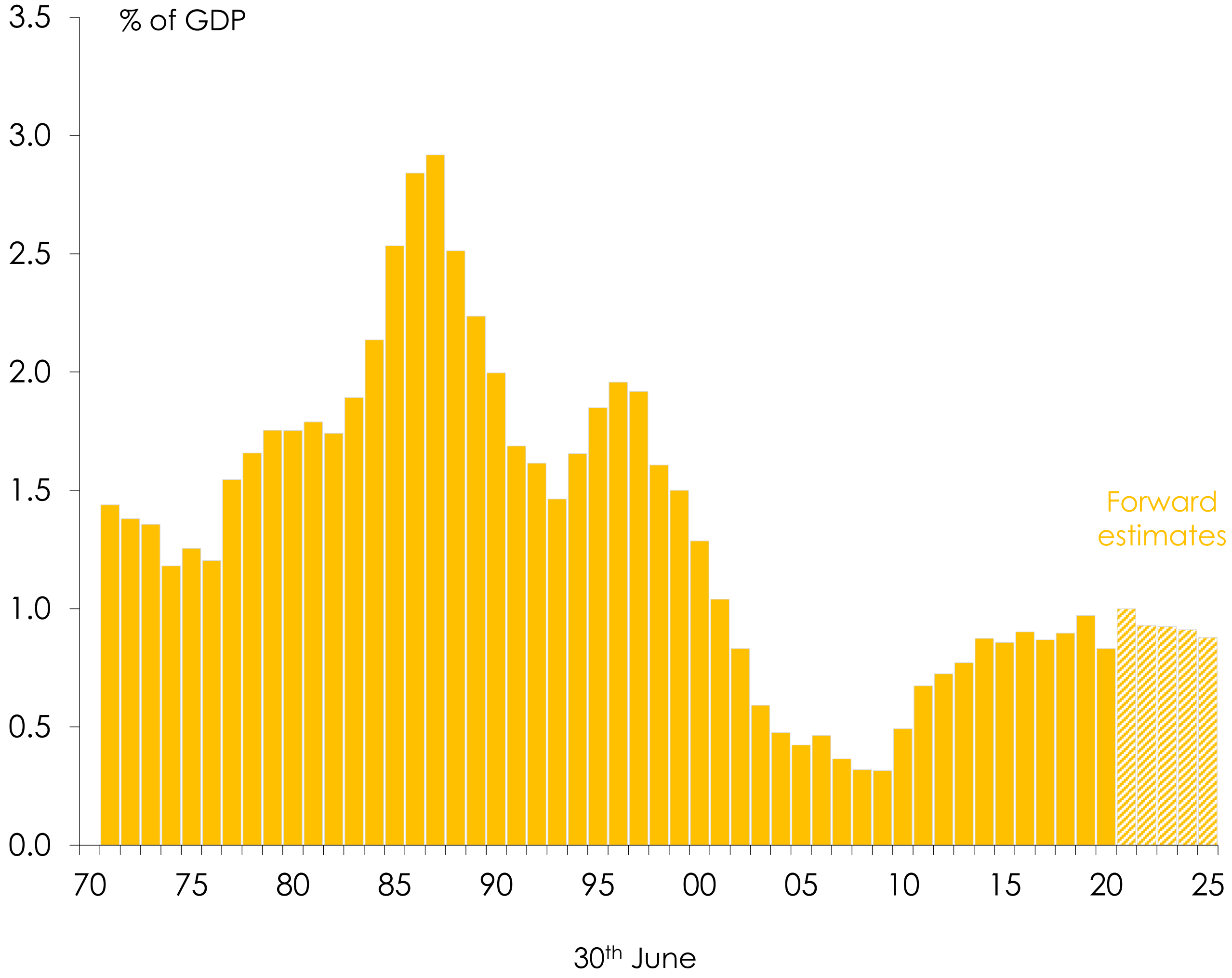
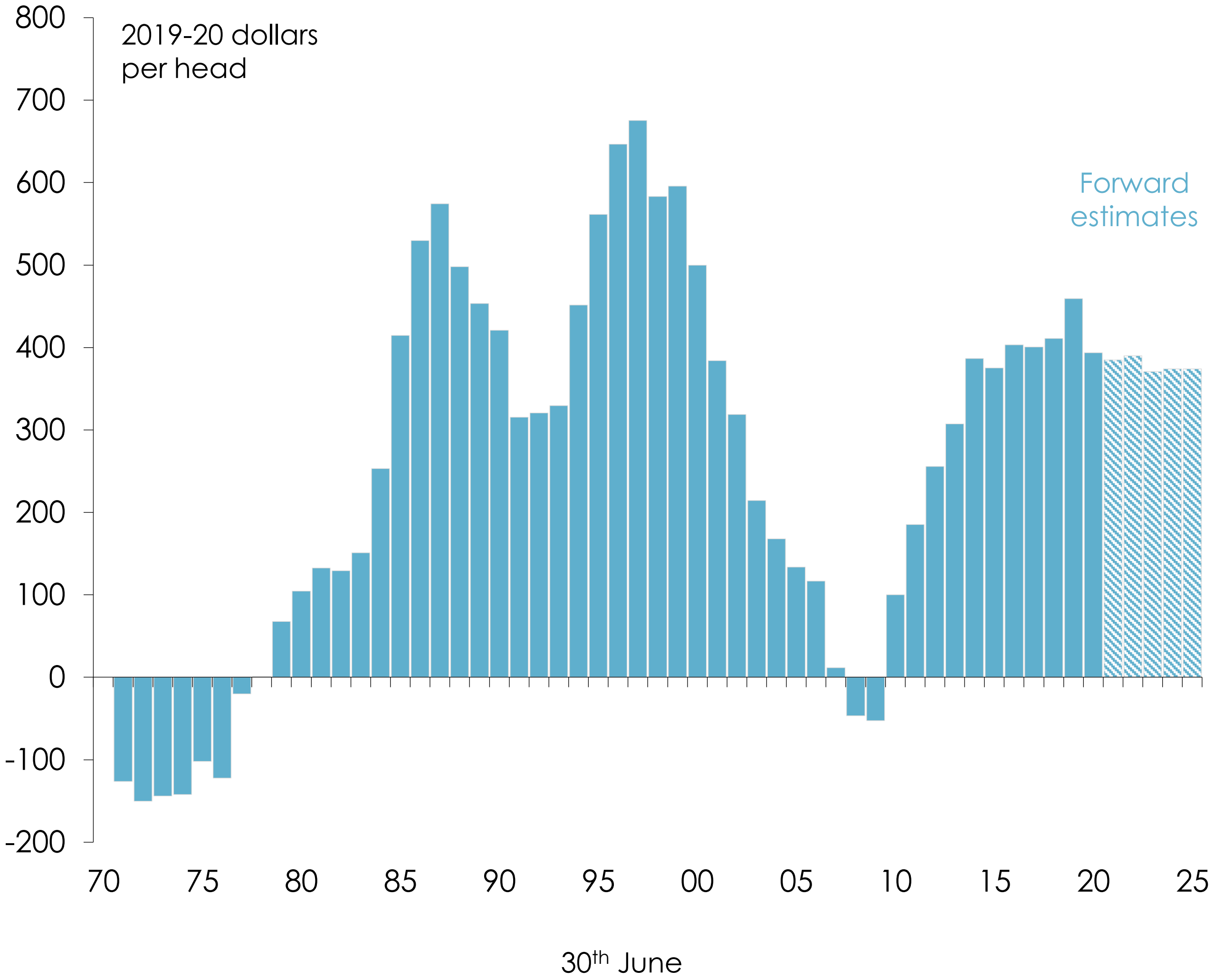
# Large as this net debt is, because interest rates are so low, the cost of servicing this debt (interest payments) is *not* especially high

## Commonwealth Government interest payments as a percentage of GDP




## Commonwealth Government net interest payments per head of population in 2019-20 dollars




*Source:* Australian Government, *2021-22 Budget Paper No. 1 - Budget Strategy and Outlook - Statement 11*.

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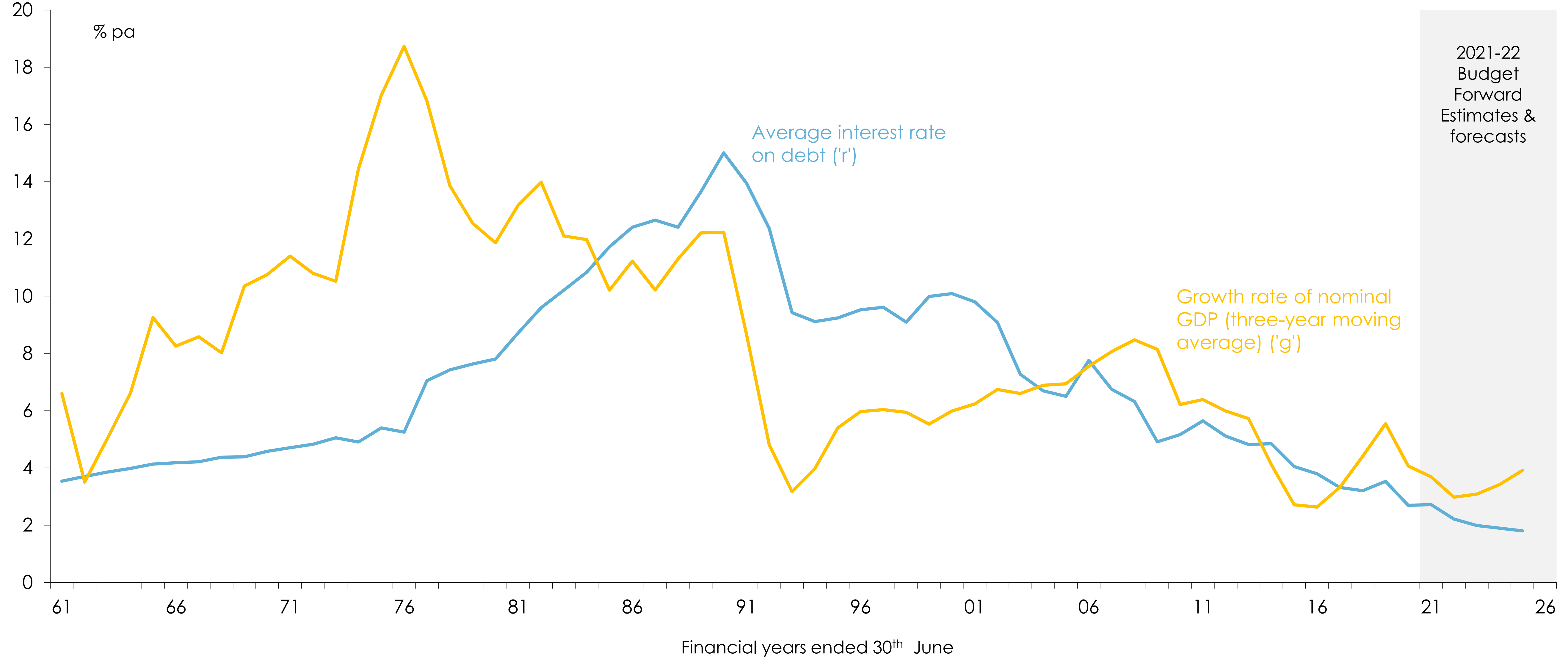
# As long as interest rates ('r') and budget deficits are less than the growth rate of the economy ('g'), the level of public debt will be sustainable

## Interest rates on Commonwealth Government debt vs nominal GDP growth




*Note:* average interest rate on debt calculated as gross interest payments as a percentage of the face value of government securities on issue as at the beginning and end of each financial year. *Sources:* Australian Government, 2021-22 Budget Paper No. 1 - Budget Strategy and Outlook - Statement 11 and Archive of Budgets; ABS, Australian System of National Accounts, 2019-20.

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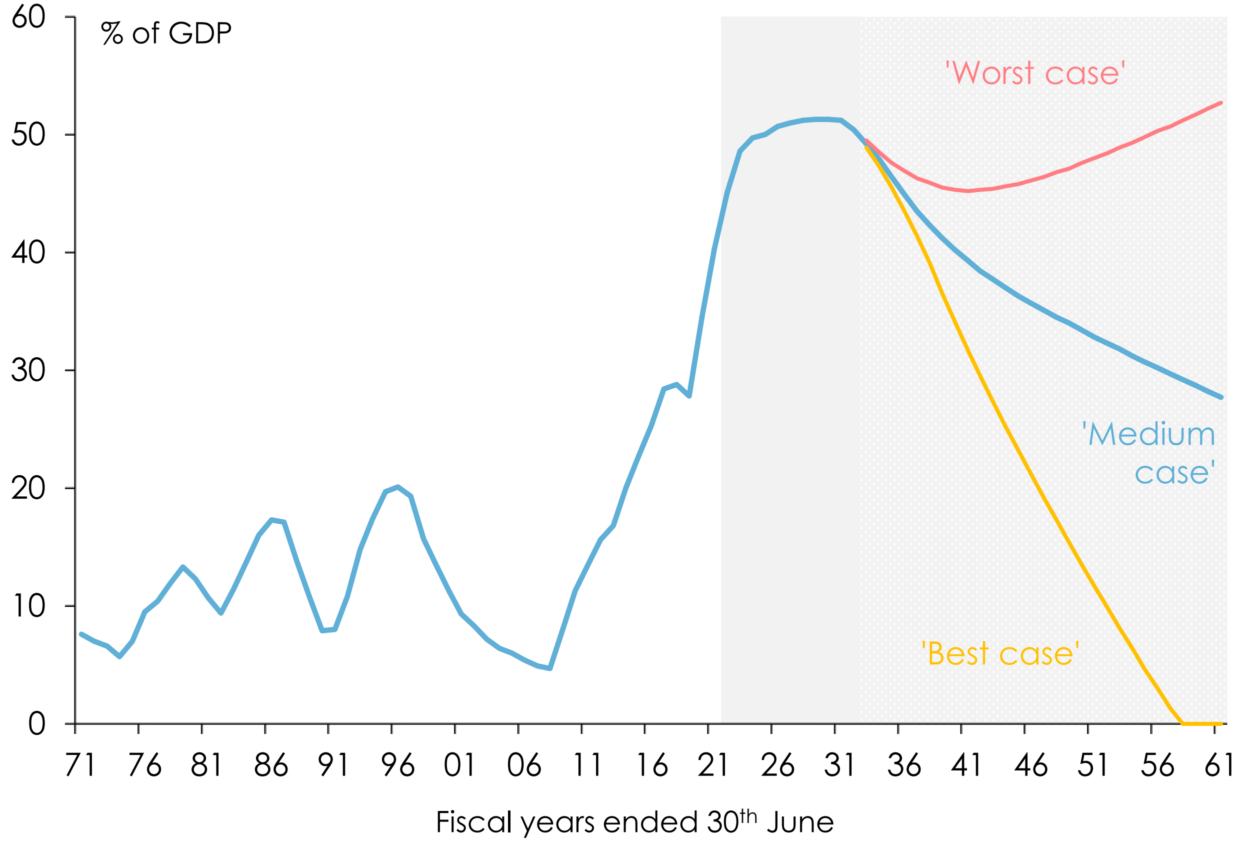
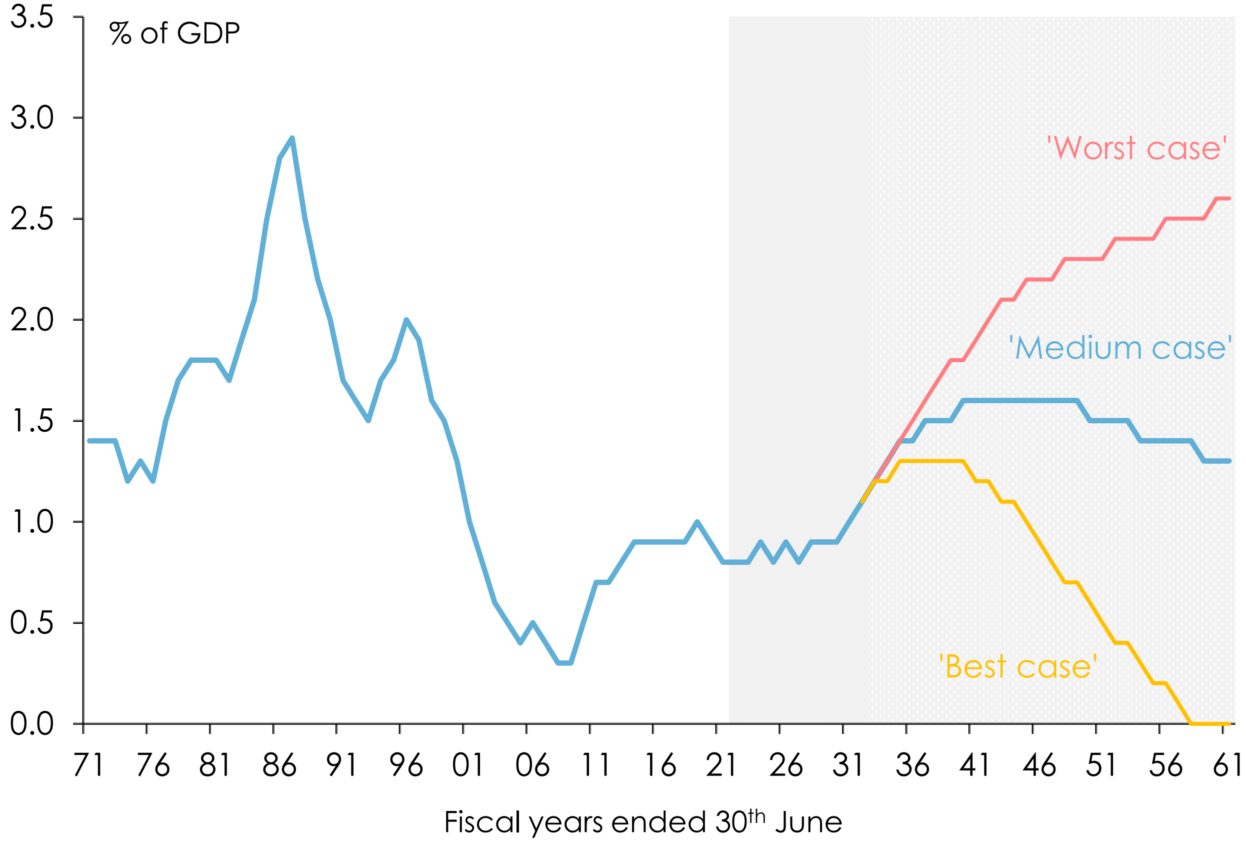
# Analysis by the Parliamentary Budget Office suggests the debt which the Government has incurred *is* sustainable under a wide range of scenarios

## PBO projections of Commonwealth Government gross debt




## PBO projections of Commonwealth Government interest payments




- **The PBO derived projections of gross debt and interest payments over the next 40 years based on 27 combinations of different assumptions about economic growth, interest rates and the budget balance**
- **Under all of these scenarios (even the 'worst case'), both total debt and debt-servicing costs remain within the bounds of historical experience**

*Source:* Parliamentary Budget Office, *Beyond the Budget: Fiscal outlook and scenarios*, 21st September 2021.



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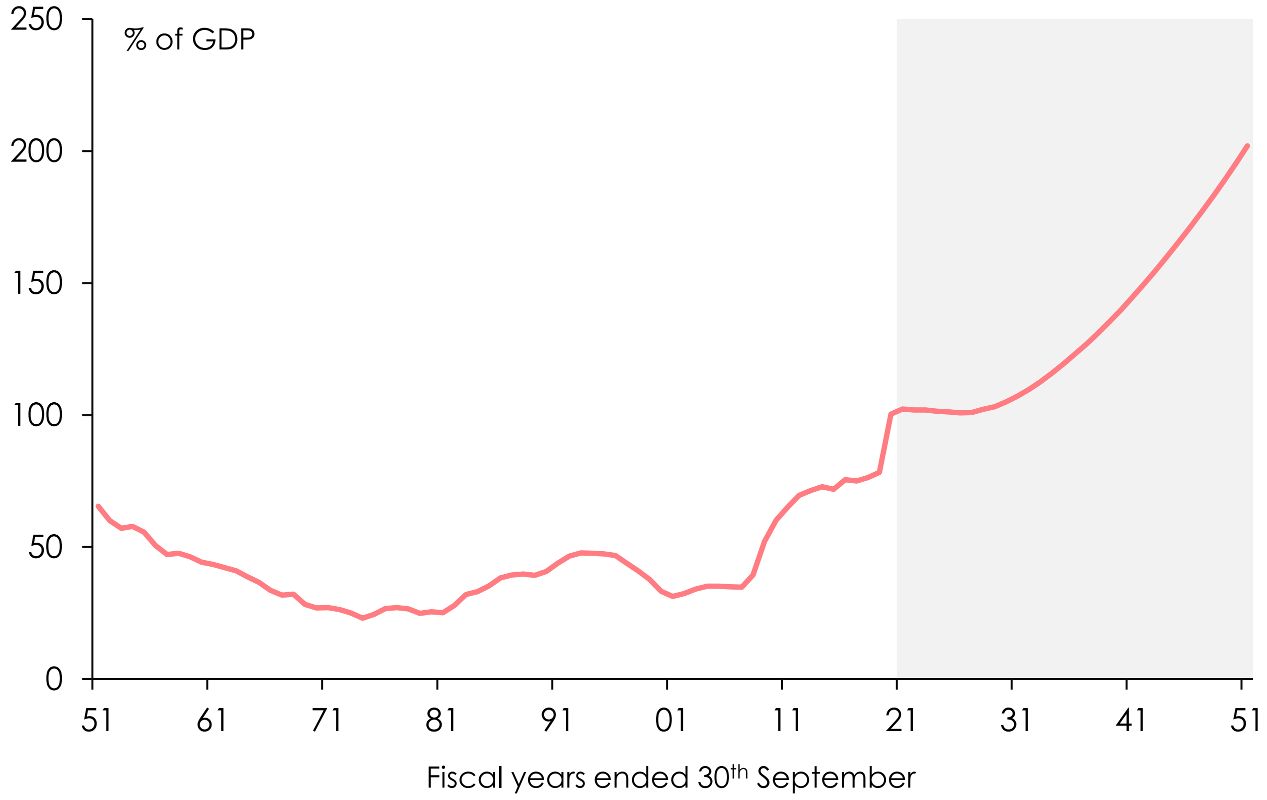
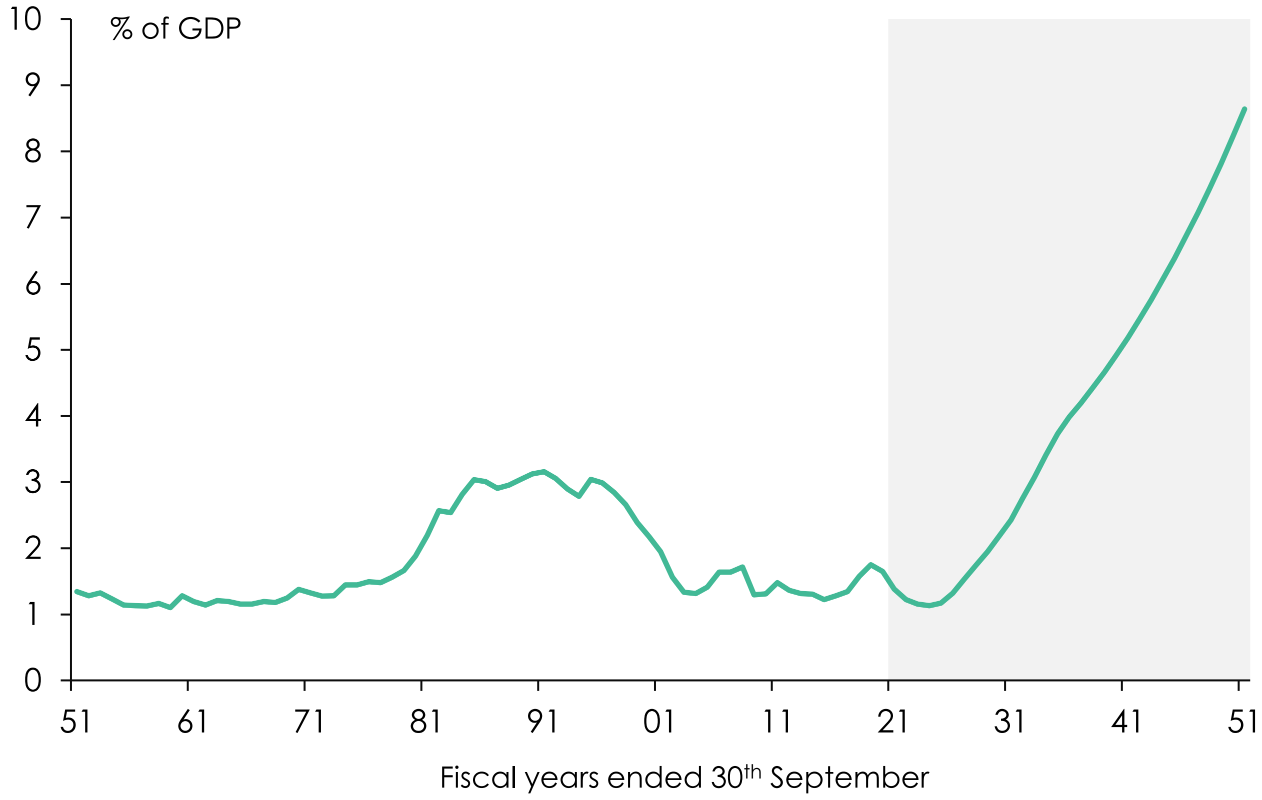
# Whereas a similar analysis by the US Congressional Budget Office suggests that the US Government's debt position is *not* sustainable

## CBO projections of US Federal Government gross debt




## CBO projections of US Federal Government interest payments

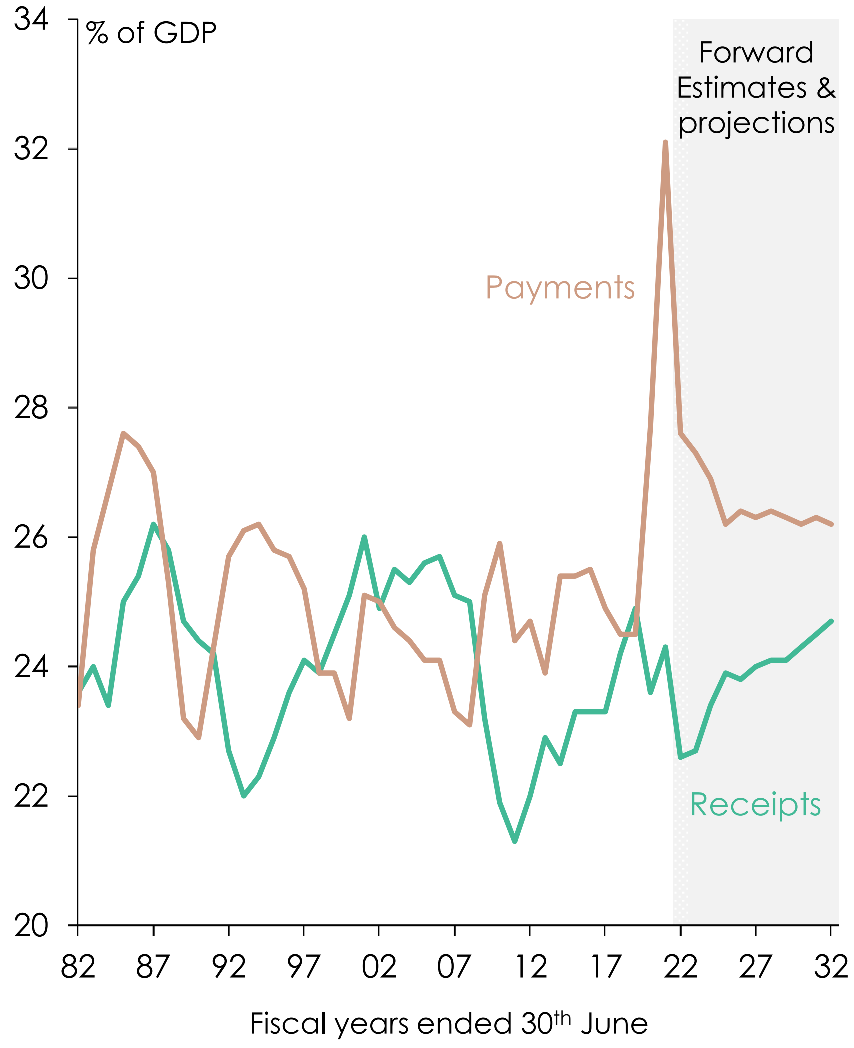



- **The CBO assumes real GDP growth slowing to 1.5-1.6% pa from 2027 onwards, inflation averaging 2.2-2.5% pa, and the average interest rate on Federal debt rising from 1.2% pa to 4.6% pa by 2051**
- **But without significant policy changes, the CBO expects the budget deficit to continue widening (to over 10% of GDP from the early 2040s) leading to an ongoing increase in both debt and interest payments to historically unprecedented levels**

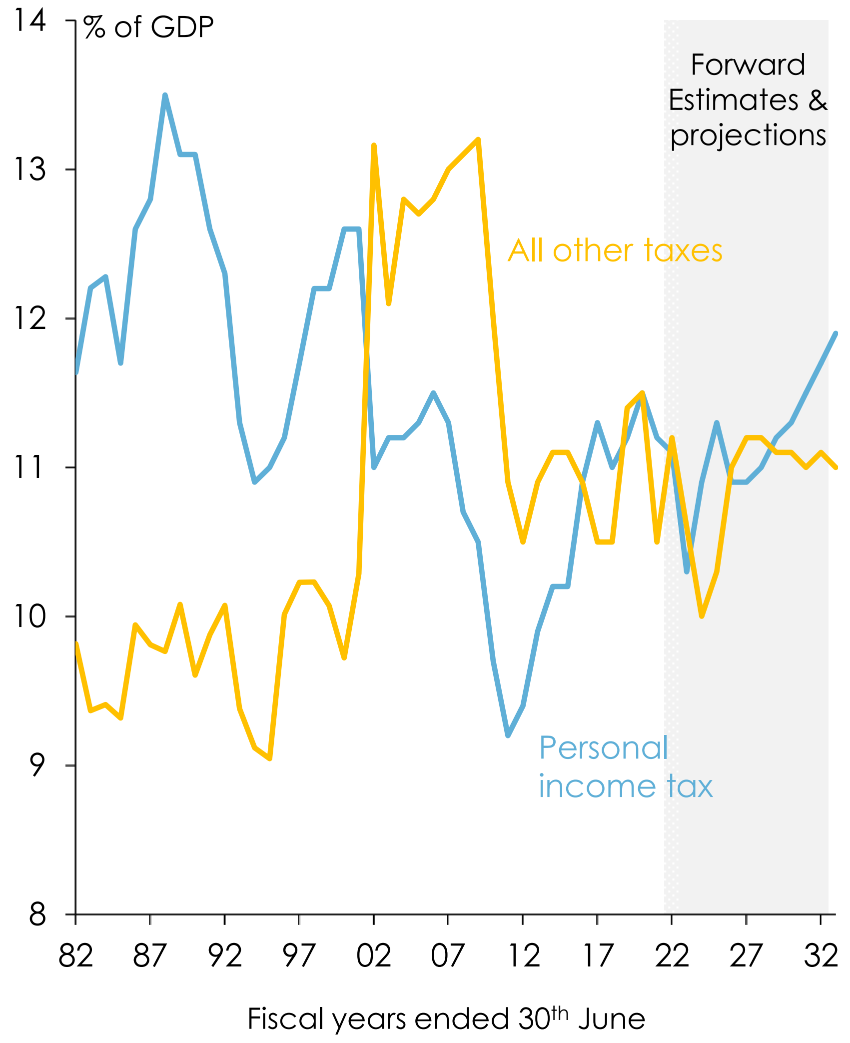
*Source:* US Congressional Budget Office, *The 2021 Long-Term Budget Outlook*, 4th March 2021.

# Australia's problem is that the Government will be relying solely on rising personal income tax collections to keep the deficit on a declining path

## Commonwealth Government receipts and payments




## Personal income tax and other tax receipts as pc of GDP




## Personal income tax receipts as a pc of total tax receipts


*Source:* Parliamentary Budget Office, *Beyond the Budget: Fiscal outlook and scenarios*, 21st September 2021.

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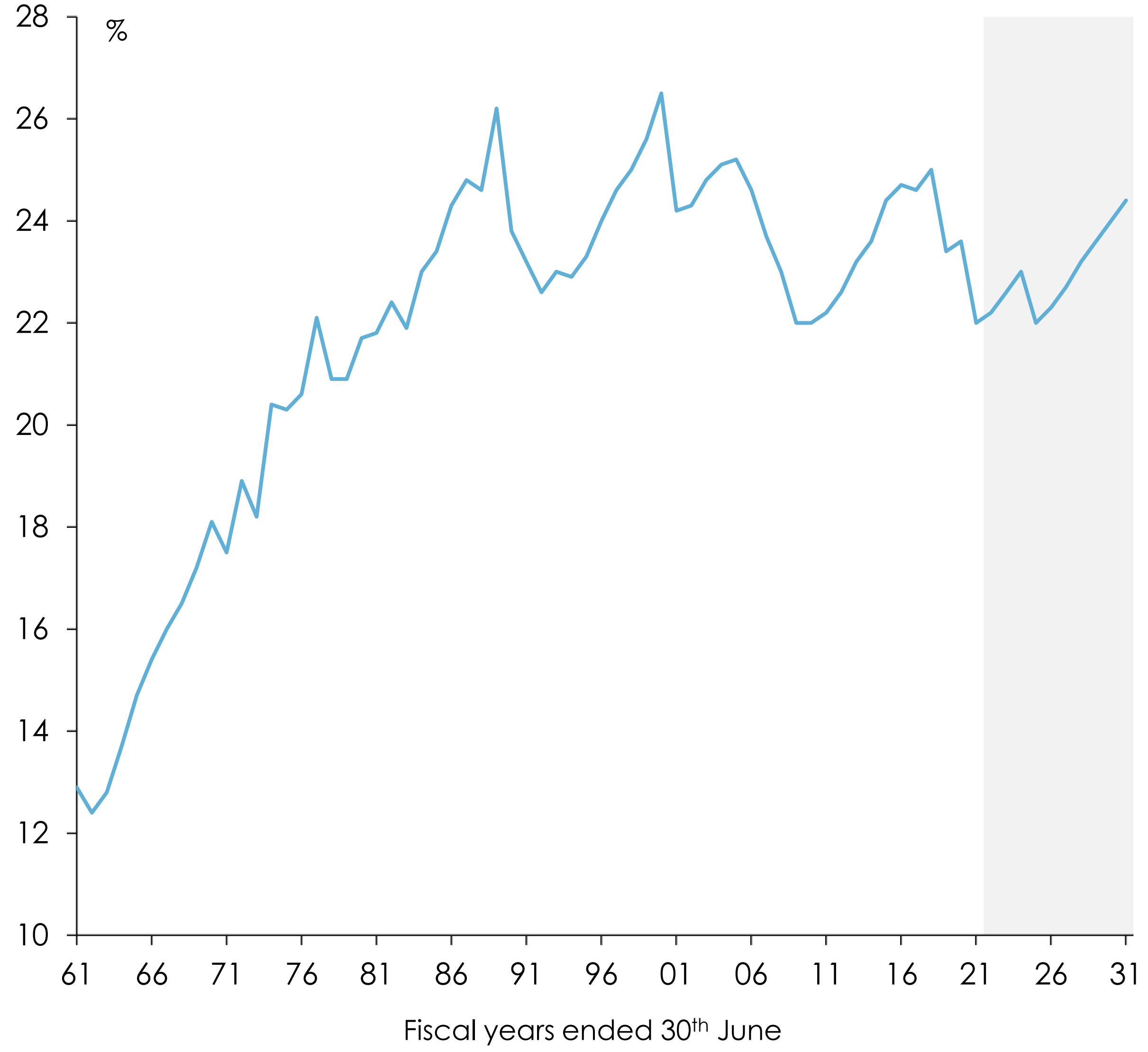
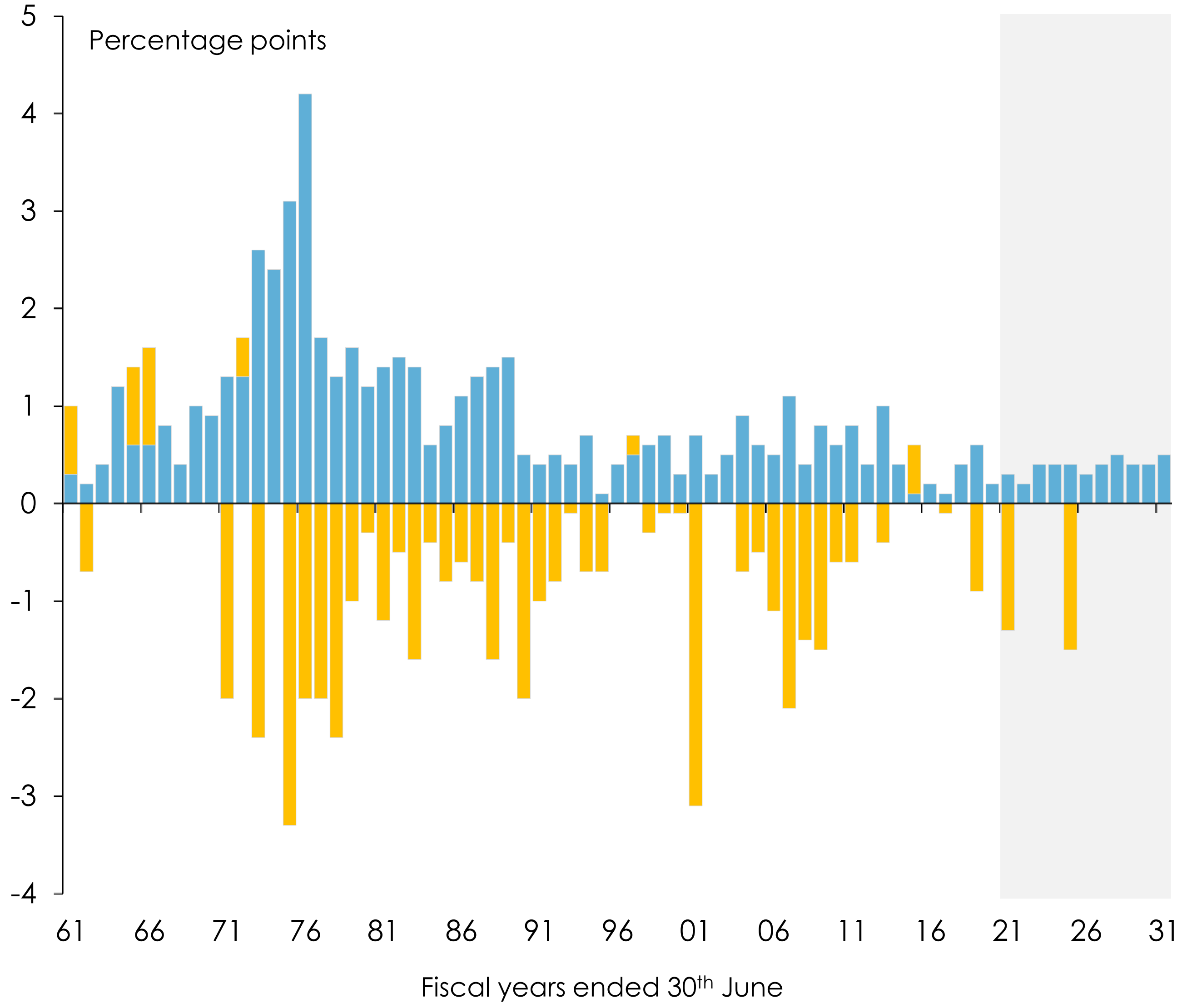
# And the prospective increase in personal income tax collections *isn't* the result of a conscious policy decision, but is rather due to 'bracket creep'

## Average personal income tax rate




## Source of changes in average personal income tax rates




*Source:* Parliamentary Budget Office, *Bracket creep and its fiscal impact*, 29th September 2021.

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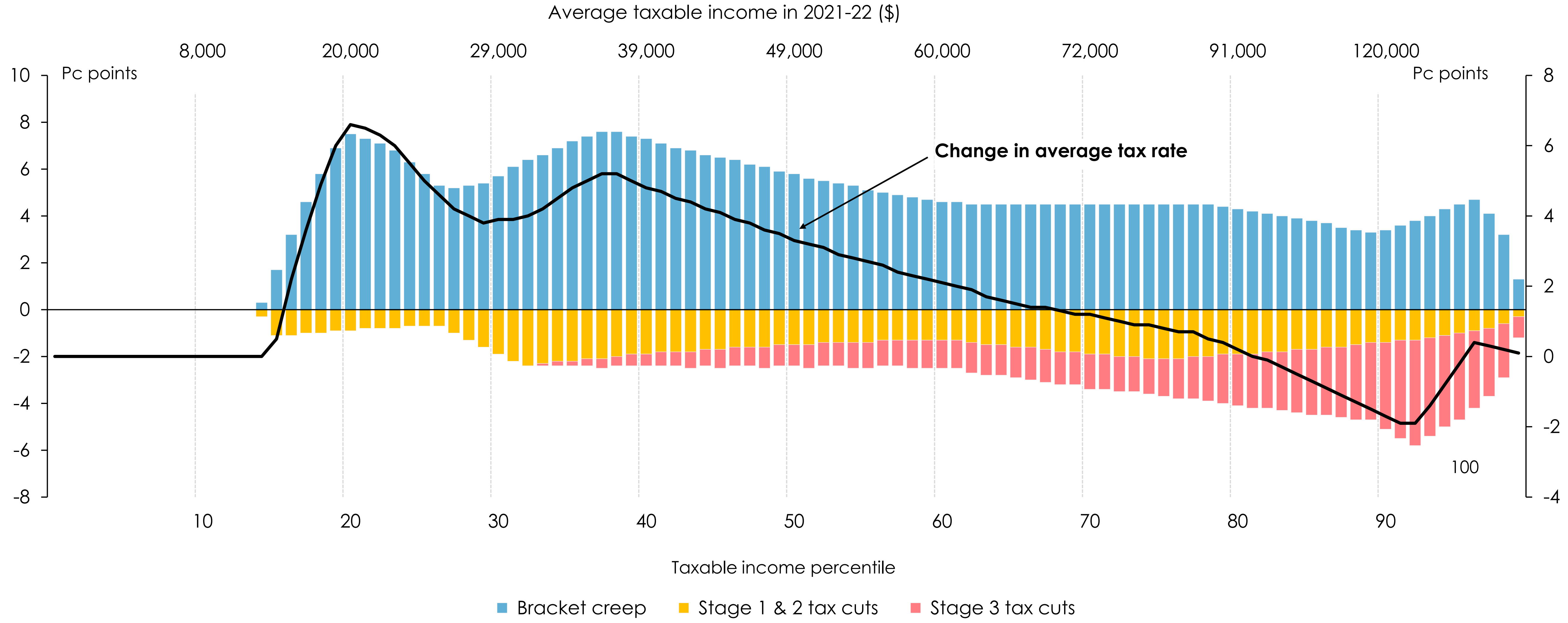
# ‘Bracket creep’ disproportionately impacts taxpayers with incomes of between $20,000 and $50,000 per annum

## Change in average tax rates between 2021-22 and 2031-32 by taxable income percentile




*Source:* Parliamentary Budget Office, *Beyond the Budget: Fiscal outlook and scenarios*, 21st September 2021.

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# Does the debt have to be 'paid off'?

- There is no principle of economics or public finance which says that the optimal level of debt for a government is zero
  - households usually want to pay off their debts because people don't like to leave debts to their children
  - but governments don't die – there is no compelling reason for them to 'pay off' debts by some arbitrary date
- On the contrary, where government spending produces benefits for future generations of taxpayers as well as the present one, 'inter-generational equity' considerations suggests that paying for some of that spending through debt which future generations of taxpayers will service is both fair and reasonable
  - in other words, the level of debt which a government owes shouldn't be evaluated independently of what it has been used for
- Very few governments have ever completely 'paid off' their national debt
  - the English/British/United Kingdom Government has always had some debt outstanding since at least 1693 (when the Bank of England was founded)
  - President Andrew Jackson reduced the US national debt to less than US$40,000 during his second term in office (1832-36) but apart from those two years the US Federal Government has always had some national debt outstanding
- Australian Governments had much higher levels of debt, as a proportion of GDP, from the time of Federation until the early 1960s, than it does now or is likely to over the next decade
- As with households, the critical question is not how big the debt is, but rather what has it been used for, and can it be serviced without requiring either crippling levels of taxation and/or unsustainable (or undesirable) cuts in other areas of spending



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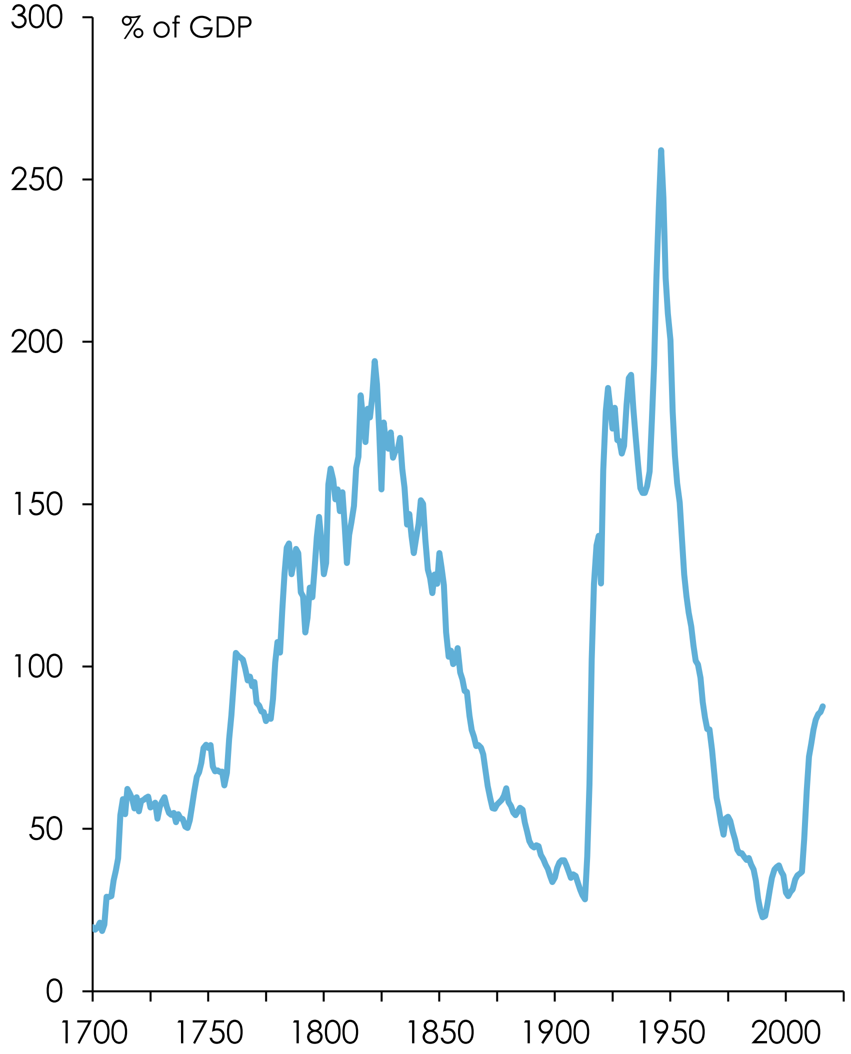
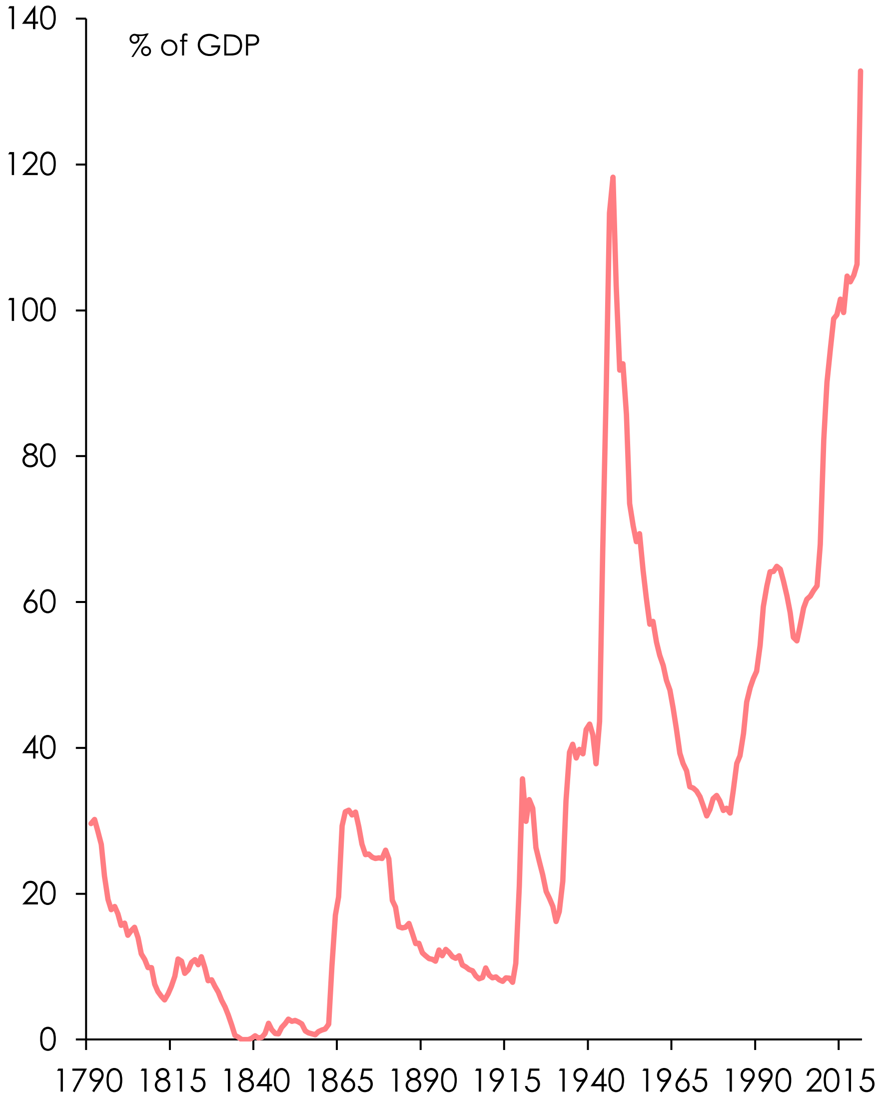
# Governments rarely 'pay off' their debt

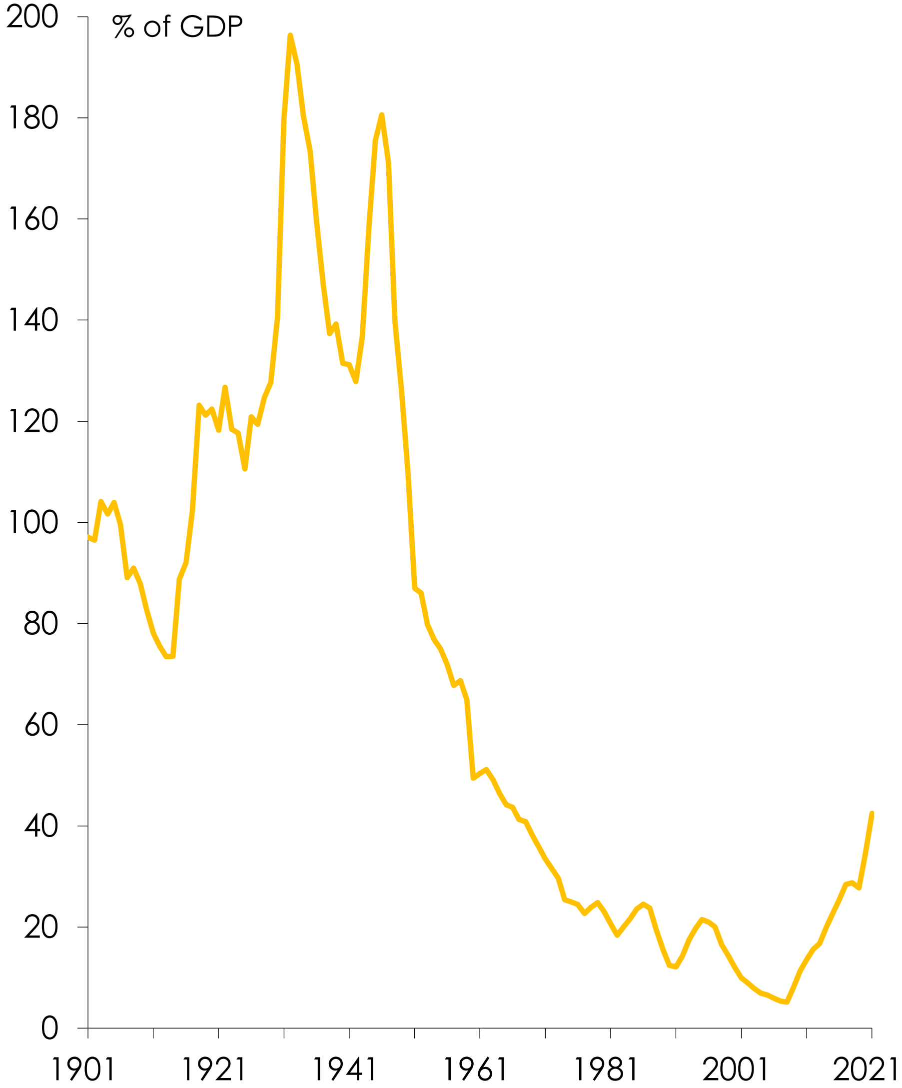
## England/Great Britain/United Kingdom national debt




## US Federal Government debt




## Australian Government debt




*Sources:* Bank of England, A millennium of economic data, Version 3.1; US Treasury, Historical Debt Outstanding; US Census Bureau, *Historical Statistics of the United States Millennial Edition Online*; Katrina di Marco, Mitchell Pirie and Wilson Au-Yeung, A History of public debt in Australia, Australian Treasury January 2009.

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# Q & A

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