



**Centre of Full Employment and Equity**

**Working Paper No. 03-10**

**The Intergenerational Report – myths and solutions**

William Mitchell and Warren Mosler<sup>1</sup>

November 2003

Centre of Full Employment and Equity  
The University of Newcastle, Callaghan NSW 2308, Australia  
Home Page: <http://e1.newcastle.edu.au/coffee>  
Email: [coffee@newcastle.edu.au](mailto:coffee@newcastle.edu.au)

## 1. Introduction

In September 2003, financial market economists applauded the Federal government's announcement of a \$7.5 billion budget surplus for 2002-03 (\$A3.9 billion was originally predicted). Treasurer Costello (2003a) said the result "reflects the Government's ongoing commitment to sound fiscal management." Costello (2003b) also said "...it puts Australia in a strong fiscal position we would be in one of the strongest positions of the world ...". On November 12, private consulting group Access Economics predicted that for the 2003-04 financial year "the strong economy will deliver the government a \$7 billion war chest to use in next May's pre-election Federal Budget ..." (Wade, 2003).

While government and business have supported the continued pursuit of surpluses for many reasons, the theme underlying the pro-surplus rhetoric has become centred on so-called intergenerational issues. Simply put, the claim is that there are a number of federal programs (such as health, social security, and education) that are sensitive to demographic factors and as the population ages, the budget 'blow out' will be unsustainable (Commonwealth Treasury, 2002: 4).

So in addition to the usual demonstrably erroneous mainstream economic arguments about the surplus reducing pressures on interest rates and promoting national saving, a new vehicle of persuasion has been introduced with rhetoric designed to strike at the heart of our life experiences – ageing, health care, and aged care.

To cement this persuasion into an 'analytical' framework, the Federal government published its long awaited Intergenerational Report (IGR) in Budget Paper No.5, one of the 2002-03 Budget documents (Commonwealth Treasury, 2002, hereafter IGR). The IGR provided a forty-year projection of Commonwealth spending and revenues assuming various demographic and economic parameters. The IGR claims that in 40 years time the number under 18 year-olds will have declined marginally but the number over 65 years of age will have more than doubled and the number of over 85 years of age will have quadrupled. Allegedly, these demographic trends will cause the cost of health and aged care and pension support to blow out and that there will be increasingly fewer tax payers in the workforce who can 'fund' the expenditure. The IGR claims that if we assume tax revenue remains a constant proportion of growing national output, the expenditure explosion will push the federal budget deficit to \$87 billion in present value terms (as at May 2002).

The IGR summarised the implications of the analysis as follows: (a) the budget cannot be allowed to reach the projected level because the increasing public debt would push interest rates up and 'crowd out' productive private investment; (b) increasing debt will also impose higher future taxation burdens for our children which will reduce their future disposable incomes and erode their incentive to work; (c) the private sector must be persuaded to save more; (d) the economy must produce more jobs and people must work longer to accumulate more funds to finance their own retirements; and (e) higher levels of immigration are required to reverse the ageing bias in the population.

The debate stimulated by the IGR has been confined to issues like, the validity of the population and economic projections contained in the report (McDonald and Dowrick, 2002); challenges to the focus on reducing spending rather than increasing taxation (McAuley, 2002); and challenges to the claim that ageing *per se* inevitably increases health spending as a percent of GDP (Kinnear, 2002). Additionally, some

commentators have seized on the IGR to promote their long-standing claims for smaller government. For example, Moore (2002) sees that “By providing an in-depth analysis relevant to major public policy questions, the Intergenerational report ... offers a basis for developing a future Liberal strategy to espouse seriously the cause of smaller government via budget reforms.”

While some of the Federal government’s real aims are sound (for example, to provide efficient and high quality health care), we will argue that the basic monetary assumptions of IGR are without any application once there is a complete understanding of the dynamics of a floating exchange rate policy in regard to the government of issue. We will argue that in fact, the pursuit of budget surpluses as a means of accumulating ‘future public spending capacity’ is not only without standing but also likely to undermine the capacity of the economy to provide the resources that may be necessary in the future to provide real goods and services of a particular composition desirable to an ageing population. We will argue that by achieving and maintaining full employment via appropriate levels of net spending (budget deficits) the Government would be providing the best basis for growth in real goods and services in the future. We conclude that in a fully employed economy, the intergenerational spending decisions come down to political choices sometimes constrained by real resource availability, but in no case constrained by monetary issues, either now or in the future.

Unfortunately, the acceptance by most commentators in Australia of the erroneous idea that the Federal government is financially constrained has allowed the IGR to be taken seriously as one of the major future issues facing the nation. Overlooked is the crucial issue of our tolerance for badly needed forgone real output, as evidenced by persistently high levels of labour underutilisation (unemployment and underemployment). Real issues like this, which will determine whether there is a real capacity by the population to enjoy adequate health and aged care in the future, are being overshadowed by an errant comprehension of monetary (non) issues.

Overall, there has been a failure to criticise the basic monetary premises underlying the IGR which rely on the erroneous belief that Federal spending is inherently financially constrained because it must be facilitated via prior taxation or debt-issuance. Further, there is a belief that budget deficits will result in higher interest rates in the future, with lower levels of capital formation and economic growth as a consequence. These misconceptions together lead to the nonsensical claim that by running surpluses now the Government will be better able (because it has ‘more funds stored away’) to cope with future spending demands.

In this paper, we challenge the validity of the IGR accounting exercise at its most elemental level and conclude that the mainstream debate is misguided at best.

## **2. The rudiments of monetary macroeconomics**

In introductory macroeconomics, the essential operations of the macroeconomic system are often well explained. Sadly, the rudiments are quickly obfuscated as professors seek to replace them with increasingly difficult formal conceptions that distort the understanding students have of actual monetary economies. In this section, the rudiments of macroeconomics are restated to ensure that a firm understanding of the options and responsibilities for modern governments is achieved (some material reflects Mitchell and Mosler, 2002).

## 2.1 Monetary economies use fiat currencies

Modern monetary economies use fiat currencies, which mean that the unit of account (including the monetary unit defined by the Australian government) is convertible only into itself and not legally convertible by government into gold as it was under the gold standard, or any real good or service. This is equivalent to a flexible or floating exchange rate policy, as contrasted with a fixed exchange rate policy. Fundamentally, the currency of issue is defined only as that which is acceptable for payment of taxes and other financial demands of the government of issue. The use of fiat currency presents the Australian government with a range of options it would not otherwise have, for example, under a fixed exchange rate policy, such as a commodity money system. Most relevant is that the government of issue (and its designated agents) is the single supplier of the currency units it demands for payment of taxes. This reality is crucial for understanding why the IGR has failed to construct the problem of demographic change correctly.

## 2.2 State money introduces the possibility of unemployment

It is the introduction of “State Money” (government taxing and spending) into a non-monetary economics that raises the spectre of involuntary unemployment. As a matter of accounting, for aggregate output to be sold, total spending must equal the total of all incomes (whether actual income generated in production is fully spent or not each period). Involuntary unemployment is idle labor offered for sale with no buyers at the current price (money wage). Unemployment occurs when the private sector, in aggregate, desires to earn the monetary unit of account, but doesn’t desire to spend all it earns, other things equal. As a result, involuntary inventory accumulation among sellers of goods and services translates into decreased output and employment. In this situation, nominal (or real) wage cuts *per se* do not clear the labour market, unless those cuts somehow eliminate the private sector desire to net save, and thereby increase spending.

## 2.3 The government deficit equals the non-government surplus

National income accounting is underpinned by an identity - the government deficit (surplus) equals the non-government (residents and non-residents) surplus (deficit). Extending the model to explicitly differentiate the foreign sector makes no fundamental difference to the analysis and so private domestic and foreign sectors can be consolidated into the non-government sector without loss of analytical insight. In aggregate, there can be no net savings of financial assets of the non-government sector without cumulative government deficit spending. In other words, the only entity that can provide the non-government sector with net financial assets (net savings) and thereby simultaneously accommodate any net desire to save and thus eliminate unemployment is the government sector. Again, it does this by (deficit) spending. Additionally, and contrary to mainstream rhetoric, the systematic pursuit of government budget surpluses is necessarily manifested as systematic declines in private sector savings.

A simple example helps reinforce these points. Suppose the economy is populated by two people, one being government and the other deemed to be the private sector (see Nugent, 2000). If the government spends 100 dollars and taxes 100 dollars (balanced budget) then the private accumulation of fiat currency (savings) is zero in that period and the private budget is also balanced. In the next period, if government spends 120 and taxes remain at 100, then the private sector has 20 dollars in saving and can

accumulate that as financial assets (in this case, 20 dollar notes although to encourage saving the government may decide to issue an interest-bearing bond). The government deficit of 20 is exactly the private savings of 20. Now if the government continued in this vein, accumulated private savings would equal the cumulative budget deficits. However, should the government decide to run a surplus (say spend 80 and tax 100) then the private sector would owe the government a net tax payment of 20 dollars. The government may agree to buy back some bonds it had previously sold. Either way the accumulated private saving is reduced dollar-for-dollar when there is a government surplus. The government surplus has two negative effects for the private sector: (a) the stock of financial assets (money or bonds) held by the private sector, which represents its wealth, falls; and (b) private disposable income also falls in line with the net taxation impost. Some may retort that government bond purchases provide the private wealth-holder with cash. That is true but the liquidation of wealth is driven by the shortage of cash in the private sector arising from tax demands exceeding income. The cash from the bond sales pays the Government's net tax bill. And note that the result is exactly the same when expanding this example by allowing for private income generation and a banking sector.

McGrath and Viney (1999: 313) state clearly "that changes in the money base are the result of the sum of the three impacts ... [Federal budget balance, official foreign exchange transactions, and net sales of Commonwealth Government securities] ... Each of the transactions ... has one thing in common – each involves a transaction between the Commonwealth government (or the Reserve Bank) and the private sector. Unlike transactions between private sector participants, which have no net effect on the amount of money in circulation, transactions between the government and the private sector do affect the amount of liquidity in the economy, and do affect the banks' abilities to extend loans. Commonwealth government transactions affect the money base or primary liquidity."

From the example above, and further recognising that currency plus reserves (the monetary base) plus outstanding government securities constitutes the net financial assets of the non government sector, the fact that the non-government sector is dependent on the government to provide funds for both its desired net savings and payment of taxes to the government is indeed supported by the mainstream literature.

Macroeconomics textbooks use a 'sectoral flows' framework to summarise the accounting of income flows between the government, private and foreign sectors. With a consolidated private sector including the foreign sector, total private savings has to equal private investment plus the government budget deficit. If we disaggregate the non-government sector into the private and foreign sectors, then total private savings is equal to private investment, the government budget deficit, and net exports, as net exports represent the net savings of non residents. If the aim was to boost the savings of the private domestic sector, given that our net exports are consistently in deficit, then as Wray (1998: 81) suggests "taxes in aggregate will have to be less than total government spending."

This framework also allows us to see why the pursuit of government budget surpluses will be contractionary. Pursuing budget surpluses is necessarily equivalent to the pursuit of non-government sector deficits. They are the two sides of the same coin. In recent years, financial engineers have empowered private firms and households with innovative forms of credit, enabling them to sustain spending far in excess of income even as their net nominal wealth (savings) declines. The resulting sharp decline in the

desire to net save has temporarily allowed the Australian government to realise a budget surplus, but the process is not sustainable (Godley, 1999; Mitchell and Mosler, 2002; Mitchell and Reedman, 2002). The decreasing levels of net savings ‘financing’ the government surplus increasingly leverage the private sector. The deteriorating debt to income ratios will eventually see the system succumb to the ongoing demand-draining fiscal drag through a slow-down in real activity.

#### 2.4 Unemployment occurs when net government spending is too low

The purpose of State Money is for the government to move real resources from private to public domain. It does so by first levying a tax, which creates a notional demand for its currency of issue. To obtain funds needed to pay taxes and net save, non-government agents offer real goods and services for sale in exchange for the needed units of the currency. This includes, of-course, the offer of labor by the unemployed. The obvious conclusion is that unemployment occurs when net government spending is too low to accommodate the need to pay taxes and the desire to net save.

#### 2.5 Government spending is not revenue constrained

Government spending is not revenue constrained. Unlike the government of issue, a private citizen is constrained by the sources of available funds, including income from all sources, asset sales and borrowings from external parties. Federal government spending, however, is facilitated in the main, by the government issuing cheques drawn on the Reserve Bank of Australia (RBA). The arrangements the government has with the RBA to account for this are largely irrelevant. When the recipients of the cheques (sellers of goods and services that are purchased by the Government) deposit the cheques in their bank, they clear through the RBA exchange settlements (ES) mechanism, and credit entries appears in accounts throughout the commercial banking system. In other words, government spends simply by crediting a private sector bank account at the central bank. Operationally, this process is independent of any prior revenue, including taxing and borrowing. Nor does the said ‘account crediting’ in any way reduce or otherwise diminish any government asset or government’s ability to further spend.

Alternatively, when taxation is paid by the private sector cheques (or bank transfers) that are drawn on private accounts in the member banks, the RBA debits a private sector bank account. No real resources are transferred to government. Nor is government’s ability to spend augmented by said debiting of private bank accounts.

In general, mainstream economics errs when it blurs the differences between the private household budget and the government budget. It is this errant analogy with the private household that is advanced by the popular government budget constraint framework (GBC) that now occupies a chapter in any standard macroeconomics textbook. The GBC is used by orthodox economists to analyse the three alleged forms of public ‘finance’: (1) Raising taxes; (2) Selling interest-bearing government debt to the private sector (bonds); and (3) Issuing non-interest bearing high powered money (money creation). Various scenarios are constructed to show that either deficits are inflationary, if financed by high-powered money (debt monetisation), or squeeze private sector spending, if financed by debt issue. While in reality the GBC is just an *ex post* accounting identity, orthodox economics claims it to be an *ex ante* financial constraint on government spending.

The GBC allegedly leads students to believe that unless the government wants to ‘print money’ and cause inflation it has to raise taxes or sell bonds to get ‘money’ in order to spend. Bell (2000: 617) says that the overwhelming and erroneous understanding that a student will gain from a typical macroeconomics course is that “the role of taxation and bond sales is to transfer financial resources from households and businesses (as if transferring actual dollar bills or coins) to the government, where they are respent (i.e., in some sense ‘used’ to finance government spending).”

What is missed in this analogy is the recognition that a household, the user of the currency, must finance its spending, *ex ante*, whereas the government, the issuer of the currency, necessarily must spend first (credit private bank accounts) before it can subsequently debit private accounts, should it so desire. The government is the very source of the funds the private sector requires to pay its taxes and to net save (including the need to maintain transaction balances), making government solvency in its currency of issue a given and a non issue.

Standard macro textbooks struggle to explain this to students. Usually, there is some text on ‘money creation’ but no specific discussion of the accounting that underpins spending, taxation and debt-issuance. Blanchard (1997: 429) is representative and says government “can also do something that neither you nor I can do. It can, in effect, finance the deficit by creating money. The reason for using the phrase ‘in effect’, is that ... governments do not create money; the central bank does. But with the central bank’s cooperation, the government can in effect finance itself by money creation. It can issue bonds and ask the central bank to buy them. The central bank then pays the government with money it creates, and the government in turn uses that money to finance the deficit. This process is called debt monetization.”

However, this conception has no application. Whatever arrangements the Treasury has with the RBA the fact is that the Government doesn’t need money in order to spend on whatever it chooses. As Wray (1998: ix) notes “in reality, all government spending is ‘financed’ by ‘money creation’, but this money is accepted because there is an enforced tax liability that is, by design, burdensome.”

## 2.6 Government debt functions as interest rate support

Government debt functions as interest rate support and not as a source of funds. Once we understand the actual process of government spending, described above, which recognises the influence that fiscal policy has on bank reserves, we then can more fully appreciate the role debt-issuance plays. Once again, mainstream textbooks are totally misleading. Blanchard (1997: 429) cautions against what he erroneously calls debt monetisation and instead claims that “most of the time and in most countries, deficits are financed primarily through borrowing rather than through money creation.” He says that borrowing is facilitated by issuing bonds. But a moment’s reflection will reveal that this description has no application in a modern fiat currency economy.

Returning to the discussion about bank reserves and drawing on our earlier two-person economy, in an accounting sense the ‘money’ that is used to buy the bonds (that is regarded as ‘financing government spending’) is the same ‘money’ (in aggregate) that the government spent. Nugent (2003) says that “in other words, deficit spending creates the new funds to buy the newly issued securities.” To use the language of central bankers, government securities function to ‘offset operating

factors that add reserves', the largest 'operating factor' being net spending by the Treasury. We learn more about this in Section 2.7.

## 2.7 The RBA administers the risk free interest rate

The central bank necessarily administers the risk-free interest rate and is not subject to direct market forces. The IGR (2002: 2) claims that fiscal sustainability allows the Commonwealth to maintain low debt levels which help "maintain low domestic interest rates" and promote "private sector investment." This reflects the standard theoretical argument linking increasing debt issuance to rising interest rates. Unfortunately, the proponents of this logic fail to understand how interest rates are set and the role that debt issuance plays in the economy. At the outset, the interest rate is set by RBA which has the choice to leave the level at 0 if it chose, regardless.

While the funds that government spends do not 'come from' anywhere and taxes collected do not 'go anywhere' (Mitchell and Mosler, 2002), there are substantial liquidity impacts from net government positions as we have already discussed. If the funds that purchase the bonds come from the government spending as the accounting dictates then any notion that government spending rations finite 'savings' that could be used for private investment is a nonsense. Nugent (2000) says "One can also see that the fears of rising interest rates in the face of rising budget deficits make little sense when all of the impact of government deficit spending is taken into account, since the supply of treasury securities offered by the federal government is always equal to the newly created funds. The net effect is always a wash, and the interest rate is always that which the Fed votes on. Note that in Japan, with the highest public debt ever recorded, and repeated downgrades, the Japanese government issues treasury bills at .0001%! If deficits really caused high interest rates, Japan would have shut down long ago!"

To understand why budget deficits operationally place downward pressure on short-term interest rates, we note that net government spending (deficits) will eventually, presuming the increased private demand for cash is less than the injection, manifest as excess reserves (cash supplies) in the ES Accounts of the commercial banks at the RBA. Exchanges between ES accounts in settlement sum to zero in terms of the system-wide balance and so in net terms the money market cash position is unchanged. As explained earlier, only transactions between the Commonwealth government and the private sector change the system balance. Government spending and purchases of Commonwealth Government Securities (CGS) by the RBA add liquidity and taxation and sales of CGS drain liquidity. These transactions influence the cash position of the system on a daily basis and on any one day they can result in a system surplus (deficit) due to the outflow of funds from the official sector being above (below) the funds inflow to the official sector. The system cash position has crucial implications for RBA monetary policy, which targets the level of short-term interest rates. The system balance is an important determinant of the use of open market operations (bond purchases and sales) by the RBA.

The RBA pays a default return equal to 25 basis points less than the overnight cash rate on surplus ES accounts. A fiscal deficit will result in a system-wide surplus, after the spending and portfolio adjustment has occurred. The commercial banks will be faced with earning the lower default return on surplus ES funds. This will put downward pressure on the cash rate. If the RBA desires to maintain the current cash rate then it must 'drain' this surplus liquidity by selling government debt. Therefore,



we confirm the point made in Section 2.6 that government debt does not finance spending but rather serves to maintain reserves such that a particular cash rate can be defended by the RBA. What would happen if the government sold no securities? The ‘penalty’ for the government that doesn’t pay interest on reserves would be a Japan-like zero interest rate, rather than the positive cash rate target. For the RBA the ‘penalty’ would be that the interest rate would fall to its support rate. Importantly, any economic ramifications (like inflation or currency depreciation) would be due to the lower interest rate rather than the government deficit.

Accordingly, the concept of ‘debt monetisation’ is a non sequitur. Once the cash rate target is set, the RBA should only trade CGS if the liquidity changes are required to support this target. Given the RBA cannot really control the reserves then debt monetisation is strictly impossible. Imagine that the RBA traded CGS with the Treasury, which then increased government spending. The excess reserves would force the RBA to sell the same amount of CGS to the private market or allow the cash rate to fall to the support level. This is not ‘monetisation’ but rather the RBA simply acting as ‘broker’ in the context of the logic of the interest rate setting monetary policy.

Ultimately, private agents may refuse to hold any more cash or bonds. With no debt issues, the interest rates will fall to the RBA support limit. It is then also clear that the private sector at the micro level can only dispense with unwanted cash balances in the absence of government paper by increasing their consumption levels. Given the current tax structure, this reduced desire to net save would generate a private expansion and reduce the deficit, eventually restoring the portfolio balance at higher private employment levels and lower the required budget deficit as long as savings desires remain low. Clearly, there would be no desire for the government to expand the economy beyond its real limit. Whether this generates inflation depends on the ability of the economy to expand real output to meet rising nominal demand. That is not compromised by the size of the budget deficit.

### **3. The intergenerational myth**

The IGR (2002: 1) sets the scene in its introduction by saying that “Commonwealth government finances are ... [presently] ... strong.” From Section 2 it is clear that Federal finances can be neither strong nor weak but in fact merely reflect a “scorekeeping” role. We have learnt that when the Government boasts that a \$7.2 billion surplus in 2002-03, this is tantamount to saying that the non-government \$A financial asset savings recorded a decline of \$7.2 billion over the same period. Thus the IGR (2002: 1) claim that the “The Commonwealth Budget recorded an accumulated cash surplus of \$23.7 billion from 1997-98 to 2000-01” is equivalent to saying that the non-government \$A financial asset savings declined by \$23.7 billion over the same period.

Equally, the IRG (2002: 1) claim that “During this period, Commonwealth government net debt, already one of the lowest among the industrialised economies, has fallen from \$82.9 billion to \$39.3 billion” is equivalent to saying that non-government holdings of government debt fell by the same amount over this period. In other words, private sector wealth was destroyed in order to generate the funds withdrawal that is accounted for as the surplus.

The IRG (2002: 1) states that this accounting record is achieved through “sound fiscal management ... [and] ... has provided the platform for vigorous, low inflationary

growth ... generating jobs and higher incomes for Australians.” Once we appreciate the equivalents noted above we would conclude that this draining of financial equity is a deflationary bias that has slowed growth and employment (keeping unemployment at unnecessarily high levels) and has forced the non-government sector into relying on increasing debt to sustain consumption.

These insights help us understand the errors in the logic underpinning the IGR and the issue in general. Financial commentators often give the impression that budget surpluses in some way are equivalent to accumulation funds that a private citizen might enjoy. Simes (2003: 4) actually suggests that an Intergenerational Fund (IGF) be established as part of “the optimal response to the ageing population will involve building up both public and private saving ahead of the period when the demographic factors bite most ... On the public side, the establishment of a special fund can help to deliver a degree of fiscal smoothing across generations.”

This has overtones of the regular U.S. debate in relation to their Social Security Trust Fund (see Eisner, 1998; Penner *et al*, 1999; Bell and Wray, 2000). Replying to the many U.S. commentators who allege that the Social Security Trust Fund is going bankrupt, Bell and Wray (2000) analyse the proposal to “to ‘use’ (current and future) budget surpluses to ‘save’ Social Security from financial collapse. Our conclusions concerning the IGF proposal mirror the arguments raised against the logic used in the U.S. context.

This idea that accumulated surpluses allegedly ‘stored away’ will help government deal with the increased public expenditure demands that may accompany the ageing population lies at the heart of the IGR misconception. While it is moot that an ageing population will place disproportionate pressures on government expenditure in the future (see Kinnaird, 2002 for an alternative), we would argue that the concept of pressure is inapplicable because it assumes a financial constraint. Once we appreciate that federal spending is not financially constrained then it is clear that the imagery invoked by the term pressure is erroneous.

The IGR (2000: 1) considers that “taxpayers’ funds” will be squeezed. But the notion that taxpayers fund ‘anything’ is misleading. As we have seen, taxes are paid by debiting accounts of the member commercial banks accounts whereas spending occurs by crediting the same. The notion that ‘debited funds’ have some further use is not applicable. The spending does not come from anywhere and when taxes are levied the revenue does not go anywhere. The flow of funds is accounted for, but accounting for a surplus that is merely a discretionary net contraction of private liquidity by government does not change the capacity of the government to inject liquidity in the future at any time it chooses (Mitchell and Mosler, 2002).

The standard GBC intertemporal analysis that deficits lead to future tax burdens is also problematic. The IGR (2002: 1) falls into this error claiming that “if policies are not adjusted, the current generation of taxpayers is likely to impose a higher tax burden on the next generation.” The problem is that the GBC is not a ‘bridge’ that spans the generations in some restrictive manner. We would rather propose that each generation is free to select the tax burden it endures. Taxing and spending transfers real resources from the private to the public domain. Each generation is free to select how much they want to transfer via political decisions mediated through the political process.

When we argue that there is no financial constraint on federal government spending we are not, as is often erroneously claimed, saying that the government should therefore not be concerned with the amount that it net spends (that is, the size of its deficit). We are not advocating unlimited deficits. Rather, the size of the government balance should reflect the spending gap that remains after private saving is at its desired rate. If the goals of the economy are full employment with price level stability then the task is to “ensure that government spending is at just the right level so that neither inflationary nor deflationary forces are induced” (Wray, 1998: ix).

This insight then puts the idea of sustainability of government finances into a different light. The IGR (2002: 1) logic is that forward planning is necessary “to ensure that governments will be well placed to meet emerging policy challenges in a timely and effective manner.” What we know is that if the Federal government continues to run budget surpluses to keep Commonwealth debt low then it will ensure that further deterioration in non-government savings will occur until aggregate demand decreases sufficiently to slow the economy down and raise the output gap.

We are not denying that over the next decades the goal should be to maintain an “efficient and effective medical health system” (IGR, 2002: 1). Clearly the real health care system matters by which we mean the resources that are employed to deliver the health care services and the research that is done by universities and elsewhere to improve our future health prospects. So real facilities and real know how define the essence of an effective health care system.

Clearly maximising employment and output in each period is a necessary condition for long-term growth. The emphasis in the IGR (2002: 2) on “encouraging mature age participation in the labour force” is clearly desirable and contrary to current government policy which reduces job opportunities for older male workers (Mitchell and Carlson, 2001). We can agree that anything that has a positive impact on the dependency ratio is desirable and the best thing for that is ensuring that there is a job available for all those who desire to work.

But this is about political choices rather than any notion of government finances. To summarise our argument, the ability of the government to provide necessary goods and services to the non-government sector, in particular, those goods that the private sector may under-provide is independent of government finance. Any attempt to link the two via fiscal policy ‘discipline’, will not increase per capita GDP growth in the longer term. The reality is that the fiscal drag that accompanies such ‘discipline’ reduces growth in aggregate demand and private disposable incomes, which can be measured by the foregone output that results. Clearly fiscal discipline “helps maintain low inflation” (IGR, 2003: 2) because it acts as a deflationary force relying on sustained excess capacity and unemployment to keep prices under control. Fiscal discipline is also claimed to increase national savings but this equals reduced non-government savings, which arguably is the relevant measure to focus upon.

#### **4. Conclusion – the solution is full employment**

Four major points have been made in this paper. First, the idea that it is necessary for the Federal government to stockpile financial resources to ensure it can provide services required for an ageing population in the years to come has no application. It is not only invalid to construct the problem as one being the subject of a financial constraint but even if such a stockpile was successfully stored away in a vault somewhere there would be still no guarantee that there would be available real

resources in the future (see Foster, 1981, Wray, 1999). Second, if the constraint on what can be done in the future is the availability of real resources then there is no reason why the pursuit of budget surpluses will serve to ease that constraint. Discussions about ‘war chests’ completely misunderstand the options available to the Federal government in a fiat currency economy. Third, the best thing to do now is to maximise incomes in the economy by ensuring there is full employment. This requires a vastly different approach to fiscal and monetary policy than is currently being practised. Fourth, if there is sufficient real resources available in the future then the distribution of them between competing needs becomes a political decision which economists have little to add.

Long-run economic growth that is also environmentally sustainable will be the single most important determinant of sustaining real goods and services for the population in the future. Principal determinants of long-term growth include the quality of technology (which increases productivity and allows for higher incomes to be paid) and increasing the capital that workers operate with. Strong investment underpins capital formation and depends on the amount of real GDP that is saved and ploughed into infrastructure and capital equipment. Public investment is very significant in establishing complementary infrastructure upon which private investment can deliver returns. A policy environment that stimulates high levels of real capital formation in both the public and private sectors will engender strong economic growth.

The recent announcement that the Federal government had taken \$7.5 billion worth of spending out of the economy over 2002-03 and by all reports is headed for a similar surplus in 2003-04 has led to some interesting reactions which are relevant in this regard. There are signs that the obsessive pursuit of budget surpluses has finally begun to provoke dissension within conservative ranks even though the logic used to express the dissatisfaction is amiss. The Deputy Prime Minister in reaction to the October surplus said that “Australia needs to prepare for the needs of its ageing population, by spending more on infrastructure ... that is a higher priority than tax cuts” (see <http://www.abc.net.au/news/newsitems/s964984.htm>). He was reported as saying “Our research shows very clearly that better infrastructure grows a bigger economy ... That creates of course a bigger tax base, which will help us cope with the costs of an ageing society ... Otherwise, we will face a future where we haven’t maximised job outcomes, we’ve reduced economic growth and where we’ve created a funding catch-up nightmare for our children.” While the link between the bigger tax base and the ability to service the ‘costs of an ageing society’ is spurious the recognition that surpluses merely destroy purchasing power is long overdue. The Deputy Prime Minister is correct in the sense that building capital and providing incomes now for those not employed will be the way in which any spending tensions (compositional debates) arising from the ageing population will be best mediated.

At each point in time, the distribution of the economy’s production between public and private sector and between competing demands within the public domain cannot be resolved by economics. The decision is ultimately a political decision and in a transparent, information rich democracy the outcomes will reflect the preferences of the majority of the population.

#### 4.1 A final irony

A current mainstream belief is that for all practical purposes there is no real investment that can be made today that will remain useful 50 years from now apart

from education, in the hope that when the time comes we will best be able to deal with whatever real problems arise. Unfortunately, they choose to address the problems of the distant future as monetary problems, and conclude that we need 'austerity' today to prepare us for the future. And, both ironically, and as evidence of the lack of understanding of the real problems we could be addressing, public education is universally one of the first expenditures that is reduced.

## References

- Bell, S. (2000) 'Do Taxes and Bonds Finance Government Spending?', *Journal of Economic Issues*, 34, 603-620.
- Bell, S. and Wray, L.R. (2000) 'Financial Aspects of the Social Security "Problem"', *Working Paper No. 5*, Center for Full Employment and Price Stability, available at <http://www.cfeps.org/pubs/wp/wp5>.
- Blanchard, O. (1997) *Macroeconomics*, Upper Saddle River, Prentice-Hall.
- Commonwealth Treasury (IGR) (2002) *Intergenerational Report 2002-03*, *Budget Paper No. 5*, May 14, Commonwealth of Australia.
- Costello, P. (2003a) '2002-03 Final Budget Outcome', Press release 085, available at <http://www.treasurer.gov.au/tsr/content/pressreleases/2003/085.asp>.
- Costello, P. (2003b) 'Press Transcript, Tuesday, September 30, 2003', available at <http://www.treasurer.gov.au/tsr/content/transcripts/2003/101.asp>.
- Eisner, R. (1998) 'Save Social Security from its Saviors', *Journal of Post Keynesian Economics*, 21(1), 77-92.
- Foster, J. (1981) 'The Reality of the Present and the Challenge of the Future', *Journal of Economic Issues*, 15(4), 963-968.
- Godley, Wynn (1999), *Seven Unsustainable Processes: Medium-Term Prospects and Policies for the United States and the World*, The Levy Economics Institute: Blithewood.
- Kinnear, P. (2002) 'Ageing - will the real culprit please stand up?', June, available at <http://www.onlineopinion.com.au/2002/Jun02/Kinnear.htm>.
- McAuley, I. (2002) 'Death is Inevitable, Why Aren't Taxes? — The Commonwealth's Intergenerational Report', Symposium: The 2002-03 Federal Budget, *The Drawing Board*, Sydney.
- McDonald, P. and Dowrick, S. (2002) 'Comments on intergenerational report, 2002-2003', *Technical Report*, Demography and Sociology Program, ANU.
- McGrath, M. and Viney, C. (1999) *Financial Institutions, Instruments and Markets*, 2<sup>nd</sup> Edition, Sydney, McGraw-Hill.
- Mitchell, W.F. and Carlson, E. (2001) *Unemployment: the tip of the iceberg*, Sydney, CAER/UNSW Press.
- Mitchell, W.F. and Mosler, W.B. (2002) 'Fiscal policy and the Job Guarantee', *Australian Journal of Labour Economics*, 5(2), 243-60.
- Mitchell, W.F. and Reedman, L. (2002) 'Fiscal policy and financial fragility: why macroeconomic policy is failing', in Carlson E. (ed.) *The Path to Full Employment*,

Proceedings of the 4<sup>th</sup> Path to Full Employment Conference/9th National Conference on Unemployment, University of Newcastle, 4-6 December, 167-178.

Moore, D. (2002) 'Plug the generation gap now', June, available at <http://www.onlineopinion.com.au/2002/Jun02/Moore.htm>.

Nugent, T.E. (2003) 'The Budget Deficit/The Budget Surplus: The Real Story', available at [http://www.mosler.org/docs/docs/budget\\_deficit\\_real\\_story.htm](http://www.mosler.org/docs/docs/budget_deficit_real_story.htm).

Penner, R., Solanki, S., Toder, E. and Weisner, M. (1999) 'Saving the Surplus to Save Social Security: What Does it Mean?', *Brief Series, No. 7*, Urban Institute, October, <http://www.urban.org/retirement>.

Simes, R. (2003) 'Fiscal Policy Rules in Australia', *Chifley Research Centre*, October, Canberra.

Wade, M. (2003) 'Big surplus paves way for tax cuts', *Sydney Morning Herald*, November 12, <http://www.smh.com.au/text/articles/2003/11/11/1068329561605.htm>.

Wray, L.R. (1998) *Understanding Modern Money: The Key to Full Employment and Price Stability*, Cheltenham, Edward Elgar.

Wray, L.R. (1999) 'The Emperor Has No Clothes: President Clinton's Proposed Social Security Reform', *Public Policy Note, No. 2*, Jerome Levy Economics Institute.

---

<sup>1</sup> The authors are Professor of Economics and Director of the Centre of Full Employment and Equity, and Distinguished Research Fellow, Centre of Full Employment and Equity and Principal, III Offshore Advisors, St. Croix, respectively.