# SOME FACTS ABOUT DEBT

A PER CAPITA DISCUSSION PAPER

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# About Per Capita

Per Capita is an independent progressive think tank, dedicated to fighting inequality in Australia. We work to build a new vision for Australia based on fairness, shared prosperity, community and social justice.

Our research is rigorous, evidence-based and long-term in its outlook. We consider the national challenges of the next decade rather than the next election cycle. We ask original questions and offer fresh solutions, drawing on new thinking in social science, economics and public policy.

Our audience is the interested public, not just experts and policy makers. We engage all Australians who want to see rigorous thinking and evidence-based analysis applied to the issues facing our country's future.

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## Introduction

As the federal government pumps unprecedented amounts of spending into the Australian economy to offset the damage from the worst economic shock in living memory, talk is starting to turn to the fear of the long-term debt this will create.

This fear is largely misplaced, and results from decades of a deceitful narrative that the federal budget is like a household budget. If we borrow, we must pay it back, within as short a time frame as possible, or our children will be paying higher taxes for generations – or so the story goes.

The story is fiction. Public debt is not like household debt.

When someone takes out a mortgage to buy a home, they borrow against the value of that home – the property is the asset against which the loan is secured. The value of that asset increases over time, and income rises along with inflation, so that eventually, even with interest incurred, the homeowner is able to pay off the debt within their means, and ends up with an asset that has greater value than it did at the start. The term of the loan is set so that the borrower can pay the loan off during their working life, while they maintain income sufficient to service the debt.

When the federal government borrows, it also does so against an asset, which is the productive capacity of Australia – the nation's natural and human resources. Unlike a household mortgage, though, there is no time limit on the repayment of the loan, because the productive capacity of the nation has no finite life-span: Australia will never "retire", it will continue to generate income through productive economic activity.

Therefore, unlike a household, the federal government can roll its debt over indefinitely, provided the nation's economic activity continues and Australia's productive capacity operates to its full potential. And, as the nation's economy grows, the size of the debt in proportion to national wealth, measured as Gross Domestic Product (GDP), shrinks commensurately.

The national economy is not an end in itself; it is a means by which to exchange goods and services, and distribute prosperity to ensure the wellbeing of a nation's people. While excessive public spending is problematic when economic activity is strong, the reverse is true during times of economic constraint.

As we begin to emerge from this health and economic emergency, there is likely to be a fierce battle waged over how we restore economic activity and recover from the massive loss of jobs and income.

On one side will be a push to return to the kind of economic activity that has exacerbated wealth and income inequality, and led to the crisis of anthropogenic climate change that threatens to end life as we know it. It will likely involve cuts to government spending on essential services and income support, the selling off of public assets, and increasing taxation, most probably by increasing the rate of the GST.

On the other is an opportunity to reset society to be more sustainable, equitable and enjoyable for all of us, and to pay down the debt we have taken on to protect jobs and livelihoods through this crisis without causing further damage to Australians through the imposition of austere cuts to services and incomes.

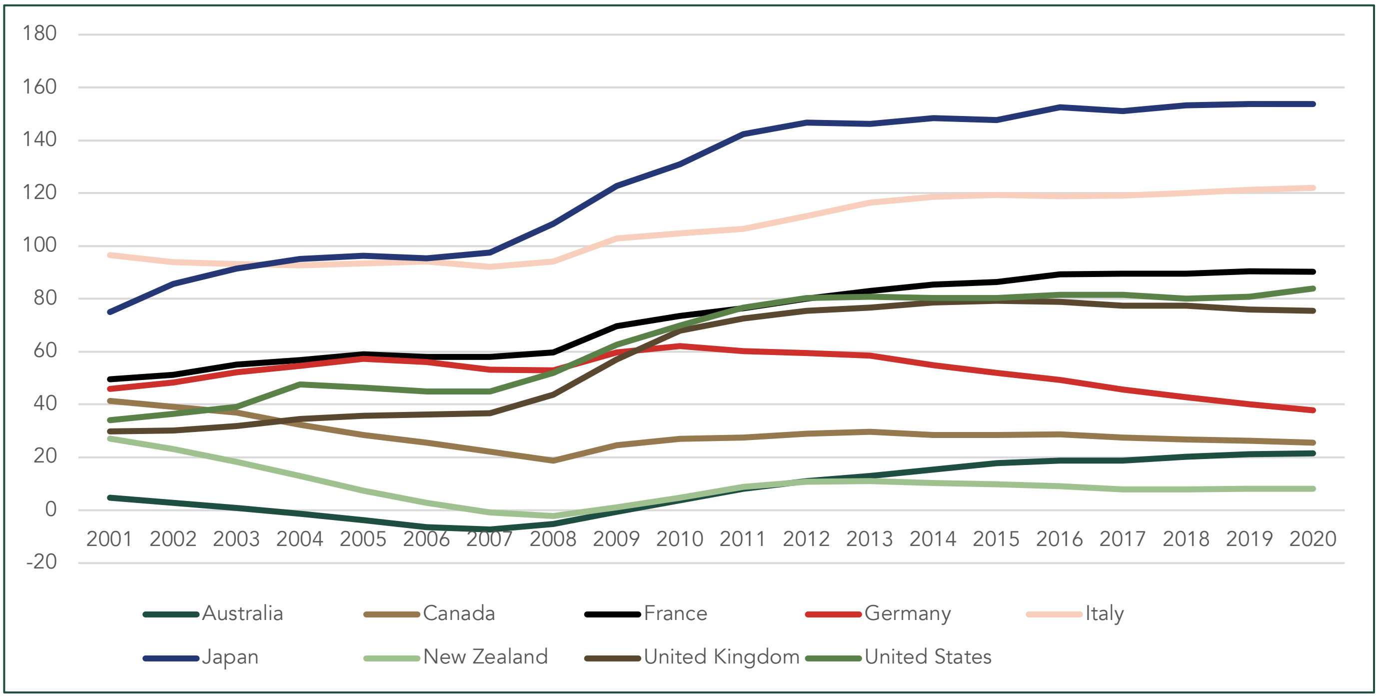
It is critical that the decisions taken in the months ahead are based on facts. What follows are some facts about debt that address the myths that have been circulated, for far too long, about the nature of our economy and its capacity to support a high standard of living for every Australian.

## *Myth: Australian public debt is very high*

## FACT: By global standards, Australian public debt is very low

At around 20%, Australia's public debt as a percentage of Gross Domestic Product is among the lowest of any advanced economy (see Figure 1).

*Figure 1: General government net debt as a percentage of GDP*




*Source: International Monetary Fund, World Economic Outlook Database, October 2019*[1]

Over the past three decades, Australian public debt has never been higher than it is currently, whereas the debt of other advanced economies has frequently exceeded 100% or even 200% of GDP.

While our public debt has doubled over the last decade, it still remains well below that of most comparable nations.

And even with the additional debt accrued to fund the *JobSeeker* and *JobKeeper* packages, Australia's net debt is currently predicted to "blow out" to just 26% - still considerably lower than the net debt carried by many comparable nations *before* their economies took a similar hit from the pandemic.

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[1] https://www.imf.org/external/pubs/ft/weo/2019/02/weodata/index.aspx

## *Myth: A budget surplus is always good; a budget deficit is always bad*

## FACT: Depending on the prevailing economic circumstances, budget surpluses can harm the economy, and deficits can help

Far too often, achieving a budget surplus is presented as a policy objective rather than merely an indicator of the state of the economy. In reality, saving for saving's sake serves no practical purpose. Balancing budgets over time is a useful fiscal discipline, but accruing large surpluses is unnecessary, and may even be counter-productive. Every dollar the government saves is money withheld from the productive economy – money that could be invested in the future health and wellbeing of the nation.

When the national economy is strong, governments rightly avoid taking on new debt, and seek to pay down existing debt. If economic activity is robust, and appropriate distributional policies in place, this can be done without cutting spending on essential social support to ensure the wellbeing of citizens. During times of economic 'boom', governments with an eye on the long-term health of the nation invest excess revenue in productive assets, including the welfare of its people. This might entail building critical transport or communications infrastructure, investing in education and skills training, or improving health and social outcomes.

Investing in the productive capacity of the economy is the best way to create a strong, resilient economy that can more easily absorb external shocks. Hoarding public wealth in a large, unproductive government surplus, or giving it away via tax cuts to boost the private savings of individuals or the profits of multinational businesses, is inherently counter-productive to the economic and social wellbeing of the nation. With millions of people now attempting to work from home, the failure to implement a world class national broadband network (NBN) during the previous economic upswing is a textbook example of how a lack of countercyclical spending can make downturns more challenging.

So, while a long-term approach to keeping the budget roughly in balance is wise, accruing and maintaining large surpluses is rarely, if ever, a good approach to economic management. In contrast, debt is rarely, if ever, a problem for advanced, stable economies like Australia's. During times of economic 'bust', or decline, it becomes essential to protecting the jobs and economic activity that are critical to our ability to restore the productive capacity of the economy and, in turn, pay down that debt.

In fact, debt serves a purpose for all complex economic entities, whether government or corporate. For example, Apple, one of the most profitable companies of all time, took on a huge amount of debt between 2014 and 2018, increasing their debt-to-asset ratio from 0.3 to 1.2. Why did Apple do this when it had US$200 billion in cash? Because debt was so cheap it allowed them to carry out acquisitions and other corporate improvements while accruing barely any interest. Market confidence in Apple's creditworthiness allowed them to offer 30-year bonds at less than 3% interest. Debt in this instance was a tool for lifting the productive capacity of the company, just as government debt can be used to increase national productive capacity.

Finally, as the government raises debt by issuing bonds, some degree of public debt is desirable for the private sector. Government bonds are a valuable, safe asset for private sector investment; eliminating public debt deprives the private sector of those bonds.

## *Myth: High public debt means the economy will be weak*

## FACT: Public debt has very little impact on Australia's GDP growth

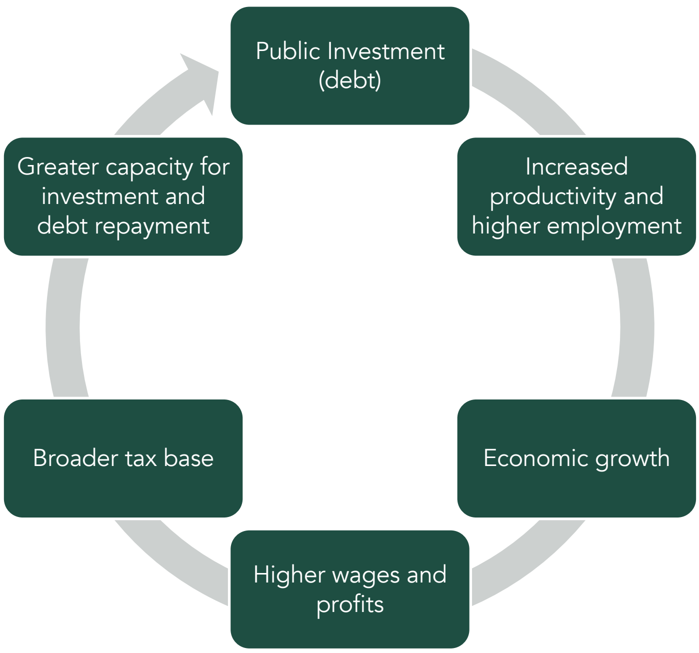
While periods of economic crisis show a correlation between higher debt and lower GDP, they are not causative and, for Australia, mostly occur during times of external shock, such as the oil crisis in the 1970s and the Global Financial Crisis just over a decade ago.

The limited relationship between debt and GDP growth has been shown to be a fairly general rule. Recent research has shown that GDP growth is not negatively affected over the long term by the presence of debt below 90% of GDP. The average long-term growth rate for countries with persistent debt at 60-90% of GDP is 3.2 per cent, roughly the same as Australia's long-term growth rate, with much lower debt levels. The growth rate declines to 2.2% when public debt is persistently over ninety per cent, but still does not result in major weakening of the economy.[2]

Well managed investments through public debt can begin a virtuous circle which increases growth, employment, productivity and demand, thereby actually *strengthening* the economy.

The *virtuous circle of public investment* leads to higher wages and profits and thus to a broader tax base. Higher tax receipts allow the government to either pay down debt or keep investing in greater economic productivity (see Figure 2).

*Figure 2: The virtuous circle of public investment*




[2] Herndon, T., Ash, M., & Pollin, R. (2010). Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff.

The International Monetary Fund recently argued that for advanced economies in good standing like Australia, so long as GDP grows faster than the interest rate on a loan, large public debt is very sustainable (Barrett, 2018), even if the government does not pay down the principal debt.[3]

Whereas household mortgage debt is constrained by the lifetime earnings of the mortgagee, and the need to amortise the principal debt to attain ownership of the asset, a country has no such limitations. In order to be sustainable, debt interest must be comfortably payable from current income.

What really matters for governments is the debt service cost. For a country, therefore, public debt is sustainable indefinitely if the interest rate is equal to or less than the growth rate of nominal gross domestic product.

[3] Barrett, P. (2018). Interest-Growth Differentials and Debt Limits in Advanced Economies. IMF Working Papers, 18(82), 1. https://doi.org/10.5089/9781484350980.001

## *Myth: Our children will be paying this off for generations*

## FACT: History shows this will not be the case

This belief is so pervasive it is frequently repeated unchallenged by journalists and commentators. Again, it assumes that taking on public debt brings the same imperatives to repay within a strict timetable as does a household mortgage.

It is true that future generations will inherit an economy with higher than usual levels of debt, but as long as we prioritise the maintenance of economic activity to support the jobs and incomes our children need to build a good life, they need not suffer due to Australia's public debt.

In previous episodes of high public debt, Australian governments used expansionary full employment policies to rapidly reduce debt after high levels of borrowing for investment. During WWII, large parts of the economy were commandeered toward the war effort, and government, unions, and the private sector all looked for ways to expand our economic capacity through innovation and large government investments. This led to a tripling of public debt in just six years, to over 120% of GDP by 1946 – its highest ever level.

Yet Australians were not '*paying off this debt for generations*'. Rather, the debt was returned to pre-war levels in around a decade.

This happened because, rather than focus on paying off the debt by cutting spending and raising taxes, the Australian government concentrated on creating a *full employment economy.* It adopted policies that created the virtuous circle of public investment.

The government harnessed many of the investments made during the war, putting into place a far more robust manufacturing sector, creating the Commonwealth Employment Service to help returned servicemen find work, and making significant public investments in productive infrastructure, with the explicit goal of creating full employment.

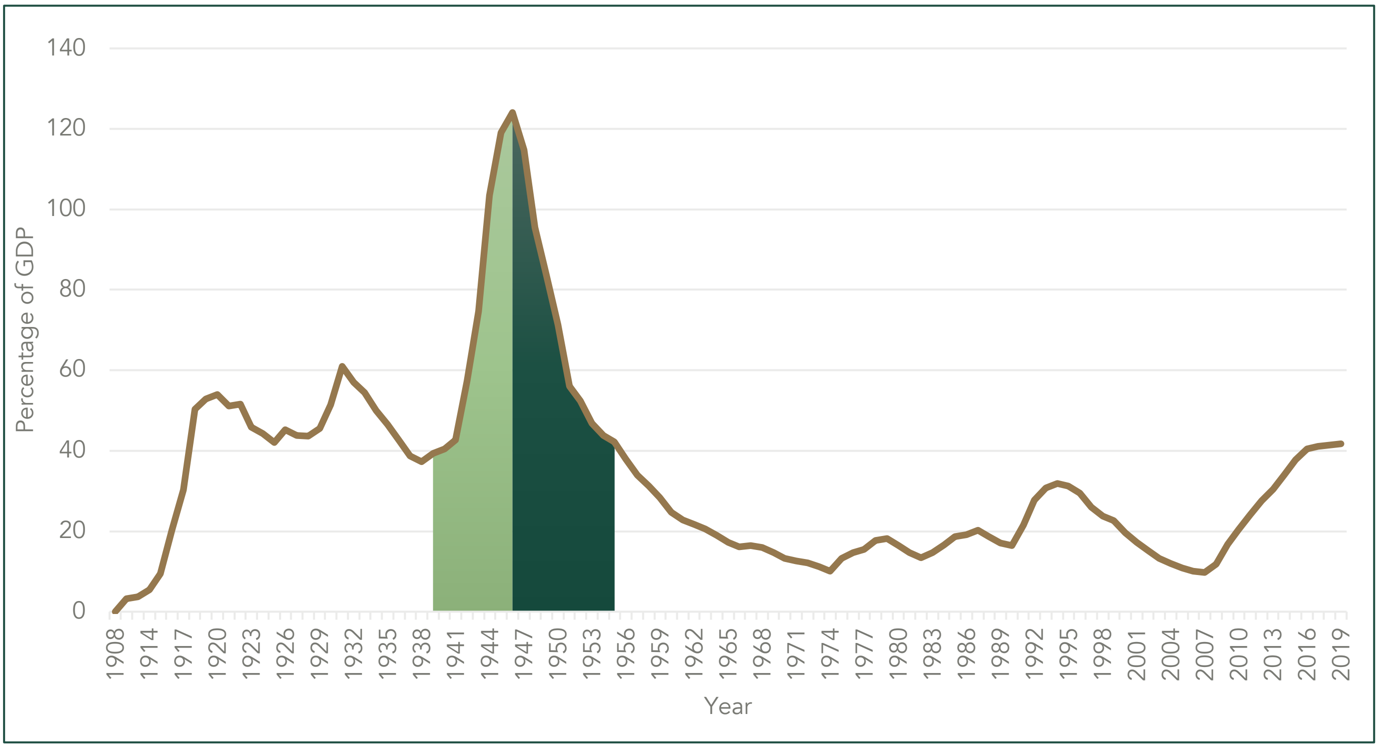
Expanding the employment base and creating productive jobs was vital to the recovery. These policies contributed to a huge increase in wages and household income, with average weekly earnings increasing by an average of 11.15% per year over the 1948-1958 decade.

The post-war years in Australia are remembered as a 'boom' time that created the most prosperous middle-class society on earth, with rising standards of living and falling inequality. It was the strongest and most stable period of economic growth in our history, averaging 4.2% of GDP in the 1950s, and rising to 5.3% in the 1960s.[4]

As a consequence, it took just 10 years to reduce public debt as a proportion of GDP to the pre-war level, with incomes, welfare programmes and investment in economic capacity increasing simultaneously (see Figure 3).

[4] https://treasury.gov.au/sites/default/files/2019-03/round3.pdf

*Figure 3: Australia's historic public debt as a percentage of GDP*



## *Myth: Australia has just spent $200 billion on the stimulus. We don't need, and can't afford, to borrow any more*

## FACT: The need for government spending has only just begun

The recent government spending has been called a stimulus, but it is not stimulus spending. It is more accurately described as welfare spending. The stimulus we need is still to come.

The government has shuttered a large proportion of the economy, and has been forced to provide income support both to households and to businesses, as we intentionally keep economic and social interactions to a minimum to combat COVID-19.

Once the public health crisis has passed, we will need to invest heavily in an actual stimulus, and this will require more spending – and, therefore, more borrowing. Tightening the purse strings too quickly will jeopardiase the recovery and may lead us down a low demand, high unemployment, low growth route.

At over 200% of GDP, Australia has some of the higest private debt levels in the world. The danger is that, if government spending is withdrawn too early, we will enter a liquidity trap: people will spend on servicing their debts rather than spending on consumption and other productive economic activity.

Despite record-low interest rates, households with already high levels of debt and reduced incomes due to collapsing employment will be loathe to borrow further. Business will be reluctant to borrow while consumer demand remains low. With reduced demand for goods and services, unemployment will remain high and wages low, and the cycle will repeat.

As we have shown, the government faces no such constraints on its capacity to borrow. It has never been cheaper than now for the government to borrow money to invest in the productive capacity of the economy, and to create new jobs.

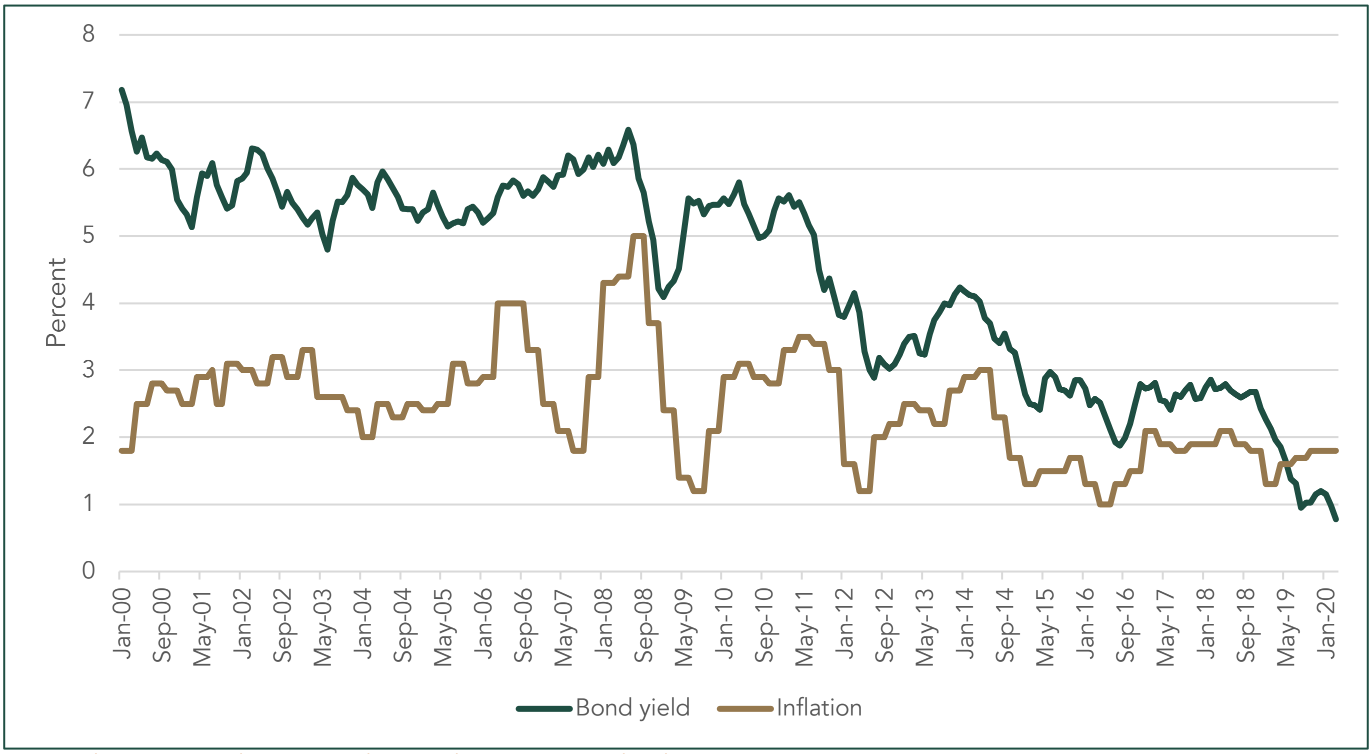
The yield on 10 year government bonds is currently less than 1%, while inflation is around 1.7%[5]. This means that borrowing is essentially interest free for the government; it is an unprecedented time for cheap investment (see Figure 4).

Once through the immediate COVID-19 crisis, the government must take advantage of these highly favourable conditions to prevent household debt from swallowing demand and stalling the recovery.

The public sector is the only engine capable of driving investment in the productive capacity of the economy, to create the jobs and growth necessary to restore household living standards, shore up business confidence and, eventually, start to pay down debt.

[5] https://www.rba.gov.au/inflation/measures-cpi.html

*Figure 4: 10-year government bond yield*




*Source:* *https://www.rba.gov.au/chart-pack/interest-rates.html*

## *Myth: Corporate tax cuts will allow businesses to invest and create jobs after the crisis*

## FACT: Corporate tax cuts have not let to investment, or to more jobs, for many years

Australia's corporate tax rate has fallen from 49% in the 1980s to the current rate of 30% (see Table 1).

*Table 1: Corporate tax rates in Australia over time*

| Statutory corporate tax rate | Time period |
|---|---|
| 45% | 1973 – 1979 |
| 46% | 1979 – 1986 |
| 49% | 1986 – 1988 |
| 39% | 1988 – 1993 |
| 33% | 1993 – 1995 |
| 36% | 1995 – 2000 |
| 34% | 2000 – 2001 |
| 30% | 2001 – present |

Source: Carlon, Tran and Tran-Nam, *How close are taxable income and accounting profit? An empirical study of large Australian companies*, Australian Tax Forum, 2013.

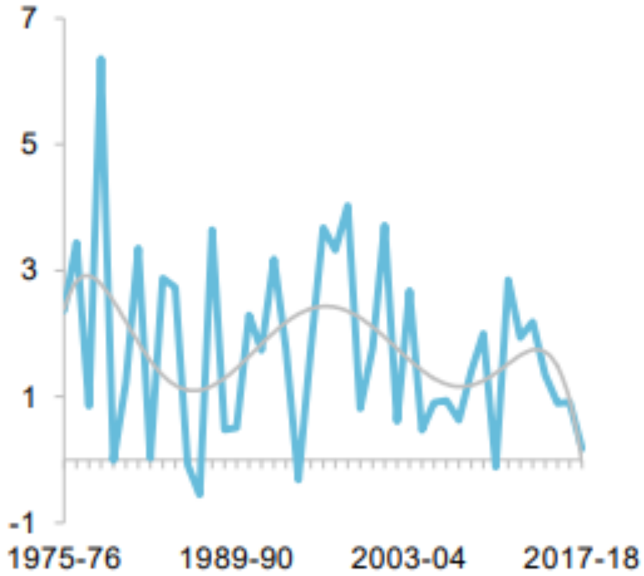
Despite relatively low taxes and rising profits, Australian business has not been contributing to productivity in proportion to those profits for many years. Labour productivity has been declining since the 1970s, to an annual growth rate of just 1.1% per year over the last five years, far below the historical average (see Figure 5).

This worrying trend has largely occurred due to a lack of capital deepening - corporate investment that typically embodies new technologies, which complement people's skill development and innovation.

Over the past few decades the Australian economy has seen a significant drop off in private sector productivity investment. In the 2017-2018 financial year, agregate indiactors showed the phenomenon of *capital shallowing*, with firms investing less than in the previous year in improving their assets.

The productivity indicators below show a significant corporate productivity crisis, a 'normal' to which we should not return following the crisis (see Table 2).

*Figure 5: Economy-wide aggregate labour productivity annual growth rates*




*Source: Productivity Commission, PC Productivity Bulletin May 2019*

Measures of Research and Development (R&D) spending by corporations, an important precursor to increasing productivity, have been very low in Australia for some time. Business enterprise research and development (BERD) has been far lower than the OECD averge since records began in 1981, and was lower in 2015 (the most recent year for which data is available) than in 2008.

*Table 2: Productivity indicators – Australia, 2003-2018*

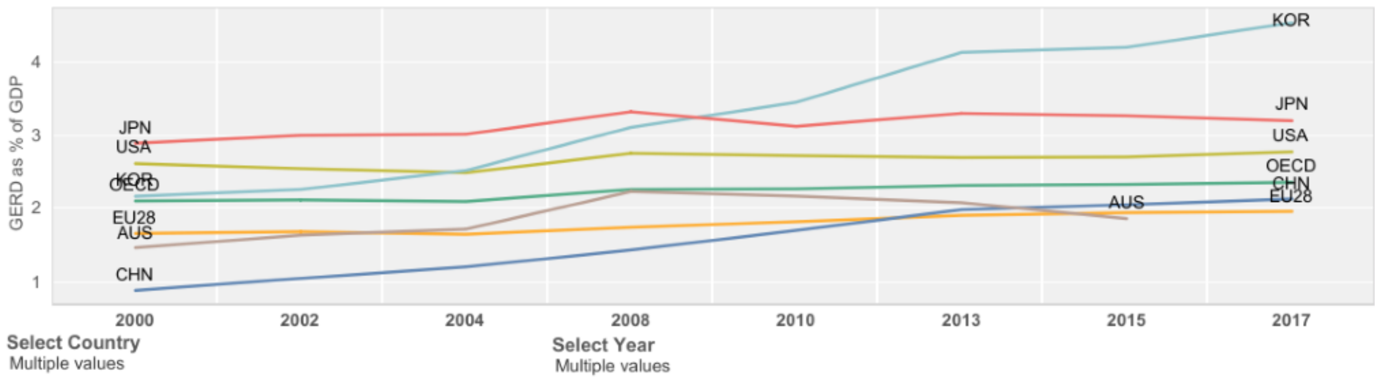
| Aggregate productivity statistics % | Long-term growth rate 1974-75 to 2017-18 | 2003-04 to 2011-12 | 2011-12 to 2017-18 | Latest years | | |
|---|---|---|---|---|---|---|
| | | | | 2015-16 | 2016-17 | 2017-18 |
| **Labour productivity** | 1.7 | 1.1 | 1.2 | 0.9 | 0.9 | 0.2 |
| **Capital-labour ratio** | 2.6 | 2.6 | 1.3 | 0.2 | 0.5 | -0.6 |
| **Capital deepening** | 1.0 | 1.1 | 0.5 | 0.1 | 0.2 | -0.3 |
| **Multi Factor Productivity** | 0.7 | 0.0 | 0.7 | 0.8 | 0.7 | 0.4 |

*Source: Productivity Commission, PC Productivity Bulletin May 2019*

This may partly be a result of long-term slackness in the Australian labour market: even before the current crisis, unemployment in Australia was stuck at 5.1%, considerably higher than in comparable advanced economies, and the underutilization rate was 13.7%, meaning that almost one in five Australians was seeking more hours of work. There is growing evidence that a tight labour market promotes innovation and productivity enhancements as employers are motivated to reduce labour costs, so a full employment economy is a means to encourage business investment in productivity gains.[6]

With a decline in government and corporate spending on R&D, our national gross R&D level is now among the lowest in the developed world. The private sector in Australia has consistently failed to adequately engage in R&D and capital investment irrespective of relatively low taxes, leaving us well behind other advanced economies (see Figure 6).

*Figure 6: R&D Intensity in OECD countries and other economies*




*Source*: OECD estimates based on OECD Main Science and Technology Indicators Database, August 2019.

Put simply, business cannot be relied upon to do the heavy lifting of increasing our national productive capacity and restoring jobs following this crisis. The government must invest directly in the productive capacity of the Australian economy, rather than cut taxes in the vain hope that business will change its behaviour. By leading the charge towards a full employment economy, government can create incentives, through labour market pressure, for business to open its purse strings and invest in a more innovative and efficient economy.

For our economy to remain sustainable over time, we must see a shift in attitude from the private sector, and a significant boost to investment in labour productivity. This will demand a new compact between business and society, in which business commits to reinvest, both in innovative technology and infrastructure, and in human resources through the provision of training and skills development. It will also necessitate a compromise between acceptable levels of profit going to shareholders and executives, and the sharing of that profit with labour through higher wages and/or shorter working hours.

In the short term, though, it is up to government to invest heavily in state-led R&D, to help get our firms back toward the technological frontier.

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[6] Bivens, J. (2017). A "high-pressure economy" can help boost productivity and provide even more "room to run" for the recovery. Economic Policy Institute, Washington, D.C. https://www.epi.org/publication/a-high-pressure-economy-can-help-boost-productivity-and-provide-even-more-room-to-run-for-the-recovery/

## Myth: Austerity measures will be needed to pay down the debt

## FACT: Austerity measures hinder rather than help economic recovery, and make it harder to pay down debt

The GFC acted as a natural experiment for government spending policy, from which lessons can be drawn for the current crisis. Many countries implemented austerity measures following the GFC with the singular goal of paying down debt. The UK government, for example, after initially agreeing to the G20 emergency stimulus package, proceeded to cut over GBP30 billion from social spending over the following decade in the pursuit of a balanced budget.

This has been shown to have been an economic mistake that has caused social catastrophe.

Austerity economics has led to a decade of poor growth, low wages and rising poverty levels across the UK. In 2018, the United Nations found that austerity measures were "entrenching high levels of poverty and inflicting unnecessary misery in one of the richest countries in the world".[7] Child poverty in the UK has soared and labour market deregulation, such as zero-hour contracts, have resulted in a poverty rate of 18% amongst households *that are in work*.

On average, UK households in 2018 were still poorer than they were before the GFC,[8] and total GDP is estimated to have been supressed by up to GBP100 billion a year as a result of the implementation of austerity policies.[9]

Figure 7 shows the trend lines of GDP per capita for Australia, Greece and the UK based on 1970-2008 data. They show how GDP per capita in the UK and Greece fell significantly below the historical trend during the austerity years.

The trend lines are particularly similar for the UK and Australia in the 1970-2008 period. However, there is a major divergence in 2008. Following the GFC, the UK never recovered to the historical trend, instead entering a period of low-spending, low-wage, low-welfare decline. The failure to invest in its economy during and after the economic crisis has reduced the UK's rate of economic recovery.

The Australian experience was quite different. The government stimulus response helped to negate the impact of the GFC and prevented a severe recession. The Australian economy had been buoyed by the resources boom, but the demand-driven approach of the Labor government played a significant role. As a consequence, the Australian economy exceeded the historical trend line by a significant margin over the following decade.

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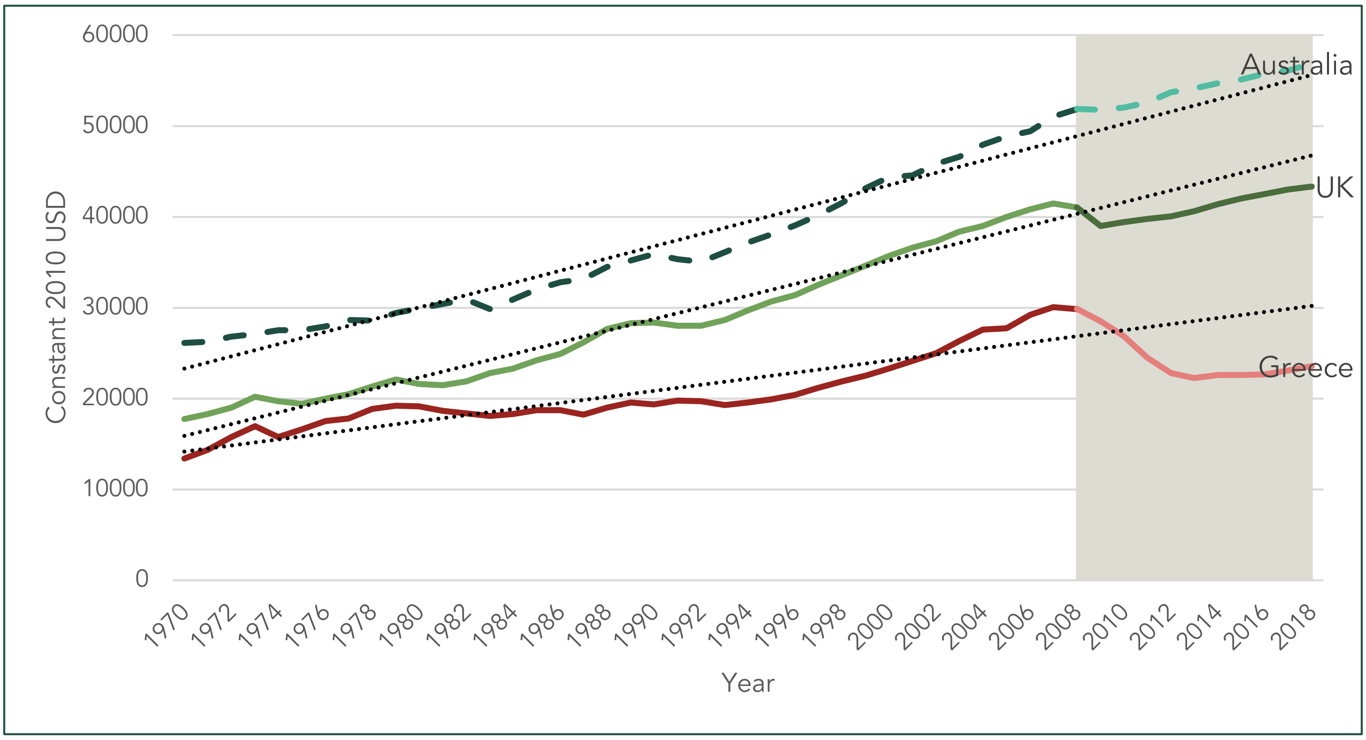
[7] https://www.ohchr.org/EN/NewsEvents/Pages/DisplayNews.aspx?NewsID=23881&LangID=E
[8] https://neweconomics.org/2019/09/the-uk-population-is-still-poorer-than-it-was-in-2008
[9] https://neweconomics.org/2019/02/austerity-hitting-uk-economy-by-almost-100bn-this-year-more-than-3-600-per-household

*Figure 7: GDP per capita before and after the GFC*




*Source: data.worldbank.org/indicator/NY.GDP.PCAP.KD?locations=AU-GR-IT-GB*

## Conclusion

There is no doubt that, during the COVID-19 pandemic, Australia has taken on a level of public debt not seen for generations. There is also no argument that this was necessary in order to protect jobs and livelihoods, and to mitigate the massive economic impact of the crisis on Australia's living standards and future economic and social health.

What comes next is critical. The spending so far has been to put the economy on life support while we ride out the essential shut-down of our usual way of life. Any expectation that the economy will spring back to life – or "snap back" to normal operation – in the aftermath of this crisis is fanciful.

Already, we are seeing arguments to raise the GST, or to reduce government spending, in order to pay off the debt. Some are calling for further deregulation of the labour market, and to cancel the annual increase in the minimum wage. And, predictably, we have seen a renewed push for business tax cuts, on the promise that they will somehow, at long last, "trickle down" to create jobs and boost household incomes.

These arguments presage a push for the Australian government to implement austerity measures to pay down public debt as soon as possible after the economic shut-down is lifted. Yet evidence from our recent and more distant history, both in Australia and internationally, shows that this path leads to soaring poverty and inequality, stifles economic growth, and reduces our ability to pay down debt.

It is not the debt itself that poses a risk to future generations of Australians; rather, it is how we choose to respond to it that will have a material impact on their prospects of building good lives, and enjoying the same, or better, standards of living than did their parents and grandparents.

The key to ensuring our children are not punished for our debt is to take the necessary measures to protect and build the economy in which they will live and work. They will need good, reliable jobs with decent incomes; a strong social safety net; access to affordable housing; and the opportunities provided by a world-class education. All these things were needed, and were becoming harder to find, even before the pandemic hit; all can be realised by investing in the productive capacity of our nation.

A new social contract is needed; one which recognises the role of government in driving investment that can support Australia to grow in an equitable, sustainable way.

To deal with debt, and create a fairer, more sustainable society, we must think differently. Instead of short-sighted actions like selling off public assets, or forcing people to dip into their superannuation, we need large-scale government borrowing to finance investments in carbon-neutral transport infrastructure, renewable energy generation, R&D incentives that actually encourage business to invest, and a rebalancing of the demands of paid labour with unpaid work and care.

Government must lead the way, but it cannot act alone. The cooperation of business, the labour movement, non-profit and non-government agencies, and every Australian citizen will be needed to restore and improve our way of life - not only to recover from the immediate crisis of COVID-19, but to deal with the existential emergency of climate change.

As we emerge from this crisis and start to rebuild, we must focus not on the debt we have taken on, but on the opportunity that lies before us: to remake our society in a way that leaves no-one behind, and ensure that our children have a future to look forward to, rather than to fear.

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