Policy Note

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The ABC of G and T

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GC Harcourt
The University of New South Wales, Australia

In the run up to the 2013–2014 Budget in Australia, discussion in the public domain has been intense, polemical and sometimes hysterical. Most commentators have, either explicitly or implicitly, argued that the principal criteria by which the Budget proposals should be judged are how do they contribute first, to returning the Budget to balance or, preferably, a surplus, and second, to reducing the debt to income ratio. Other criteria include matching particular expenditures by particular taxes or cuts elsewhere in expenditure, and an emphasis on the need for expenditure to be targeted rather than universal, so overlooking the demeaning effect of means testing. I believe that these criteria are wrong, that they distort what should be aimed at in budgets and that they have serious negative effects on equity, efficiency and levels of activity and employment.

In their place may I suggest the following criteria would be more relevant and systemically beneficial. I set these out as an antidote to decades of two fetishes: deficit size and aversion to debt, period.

First, when considering government expenditure (G), a clear distinction needs to be made between current expenditures and capital expenditures. Second, when considering taxation (T), the two main purposes of taxation need to be clearly demarcated. First, the overall structure of tax rates should reflect philosophical views on equity and incentives designed to affect the structure of the economy. Second, the other principal role of taxation is to affect the level of overall demand, having taken into account the other sources of demand which arise from the private and overseas sectors, that is to say, expected expenditures on consumption, investment, exports (less imports) and known expenditures on G. The complete structure of tax rates should be jacked up or down according to the expected levels of expenditures from these other sources so as to help to achieve desired levels of overall activity and employment. Whether G exceeds or falls short of T will reflect this prior judgment.

Turning now to debt to income ratios, it is vital, first, to distinguish between external debt and internal debt. The first does imply a real burden in the sense that exports will need to be higher than they otherwise would have been in order to service the debt with

Corresponding author:
GC Harcourt, The University of New South Wales, Sydney, NSW 2052, Australia.
Email: gch@unsw.edu.au

interest payments and repayments of principal. These are not necessarily 'bads'; it all depends on how the proceeds when spent contribute to overall growth in the economy.

Servicing internal government debt constitutes transfer payments between those who hold it and those whose taxes are used to pay it (there is, of course, an overlap). The impact on activity depends directly on any difference in the spending patterns of those who hold debt and those who don't, so that the 'burden' is different in kind from that of external debt. The redistribution of income implied may not necessarily be regarded as equitable or desirable, but offsetting measures in the overall tax system can be used to tackle this. Indirectly, there may be negative feedbacks on the confidence of those responsible for private investment expenditure, particularly if they have been conned by the two fetishes mentioned above.

As to the debt to income ratio, by world standards, Australia's position is nothing to worry about. In any event, if the overall effect of the budget is to bring about and/or support agreeable rates of growth of GDP, it is well known that even sustained deficits do not necessarily increase the debt to income ratio over the long term. A glaring weakness of the current debate is the implicit assumption that we live in a stationary state. Moreover, if government capital expenditure is principally decided by what medium- to long-term needs are to be set by the creation of suitable infrastructure, it does not seem irrational that parts of this at least be financed by borrowing. Indeed, as Ross Gittins pointed out to me, the great bulk of capital works spending in Australia is done by the states, a significant proportion of which is financed by borrowing.

If these criteria were included in an overall package deal of government policies, both our understanding and outcomes would be much more sane than those with which we are afflicted today.

If these criteria correspond to what Ross Gittins recently dubbed Rip van Winkle Keynesianism, so much the better for that. The only point on which Ross Gittins and I disagree is that he is a symmetrical Keynesian who thinks there should be a balanced recurrent budget over the cycle. I think this implicitly assumes that a trendless cycle rather than a cyclical growth process characterises capitalism ancient and modern. As for the claim that monetary policy by the independent RBA is the principal instrument of policy, it would be well to remember that two great monetary theorists told us that the bank rate is not a beautiful and delicate instrument but coarse and blunt (Dennis Robertson) and that the effects of monetary policy are subject to long and variable lags (Milton Friedman).

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