



**Centre of Full Employment and Equity**



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## **Fiscal sustainability**

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# Fiscal sustainability ...

- Now the buzzword – 2 years ago – things were different.
- We are face a daily barrage of **financial** data about the so-called deficit-sovereign debt problem.
- Ratio-fever.
- An increasingly alarmist dialogue has developed around these deficit and debt ratios:
  - The US is the next Greece!
  - China is financing America!
  - National security is threatened!
  - The advanced world is living beyond its means!

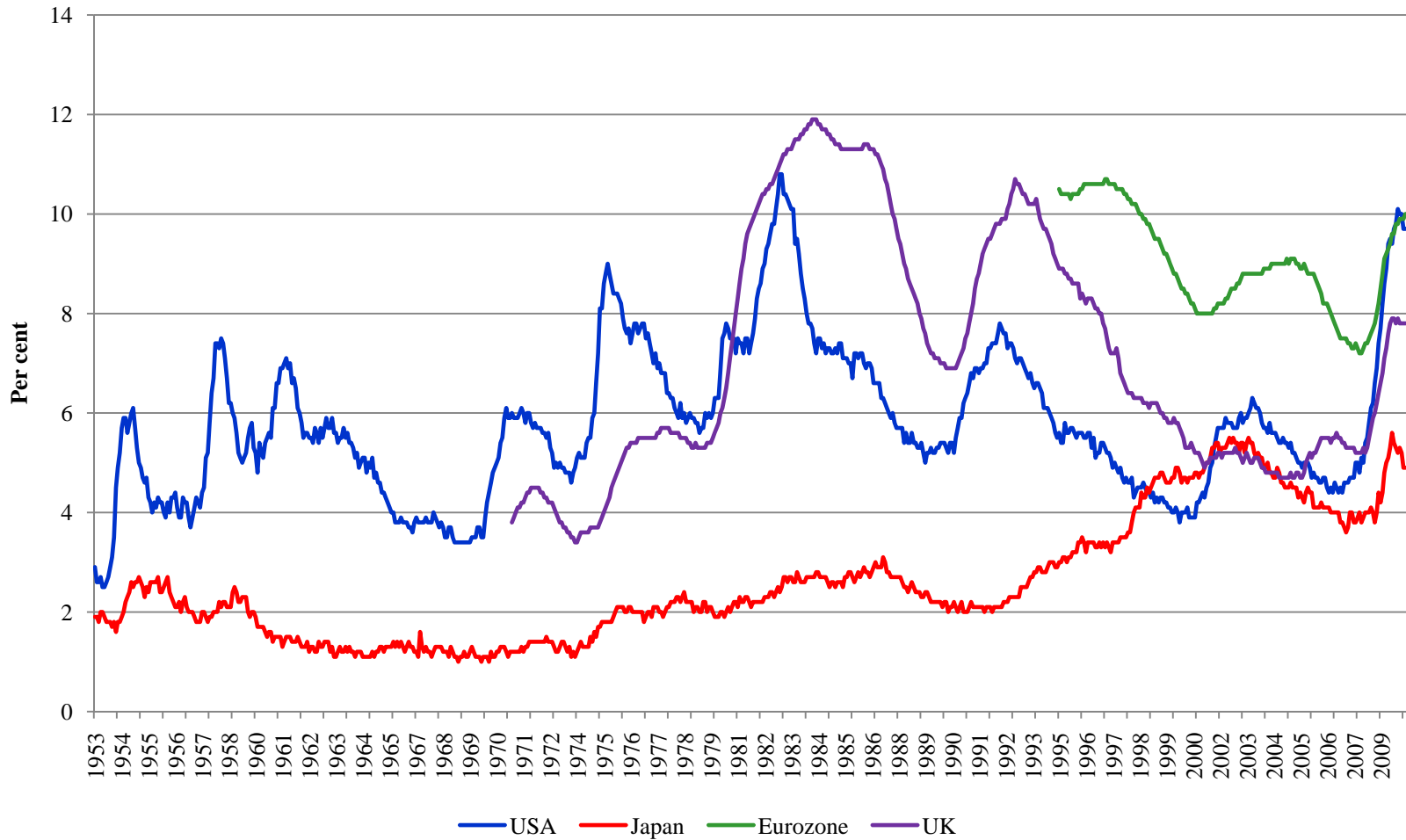
- Testimony before US Congress, 2009
  - “[Fiscal sustainability is defined] ... as achieving a stable ratio of government debt and interest payments to gross domestic product, and setting tax rates at levels that don’t impede economic growth”.
- National Commission on Fiscal Responsibility and Reform, Washington, D.C. – April 27, 2010
  - “The task of developing and implementing sustainable fiscal policies is daunting”



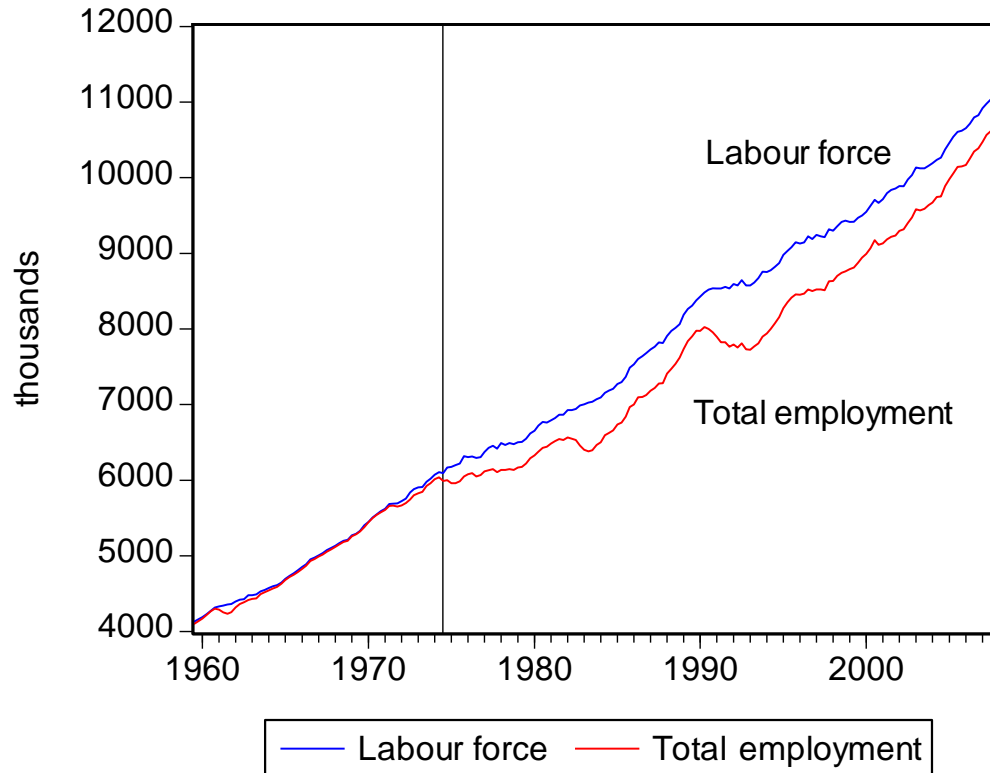
- Bernanke's definition reflects the mainstream use of models which applied during Bretton Woods period – quasi-gold standard with convertible currencies and fixed exchange rates were the defining features.
- That system ended in 1971.
- That monetary system is inapplicable now – for most nations.
- In fiat monetary systems, the national government is freed from the **financing** restrictions as a result of their non-convertible currencies and flexible exchange rates.

- Fiscal sustainability is increasingly being defined in terms of rigid fiscal rules:
  - Stability and Growth Pact (Maastricht Treaty)
  - Fiscal Responsibility Act (UK)
- Balance the national budget on average over the course of the business cycle
  - Even progressives believe this is desirable.
- There is no comprehension of what these fiscal rules and aims really mean.

# Meanwhile ... unemployment rates



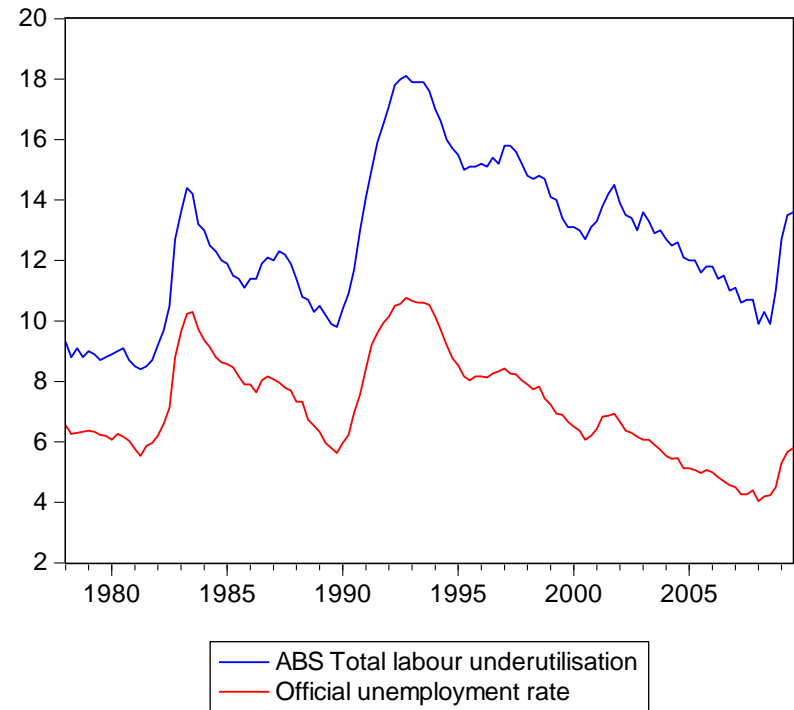
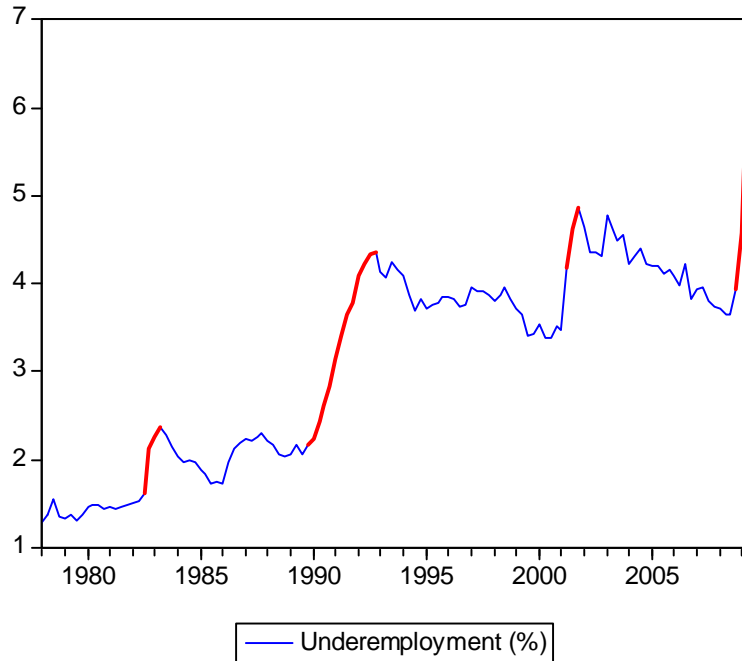
# Australia: chronic employment gap



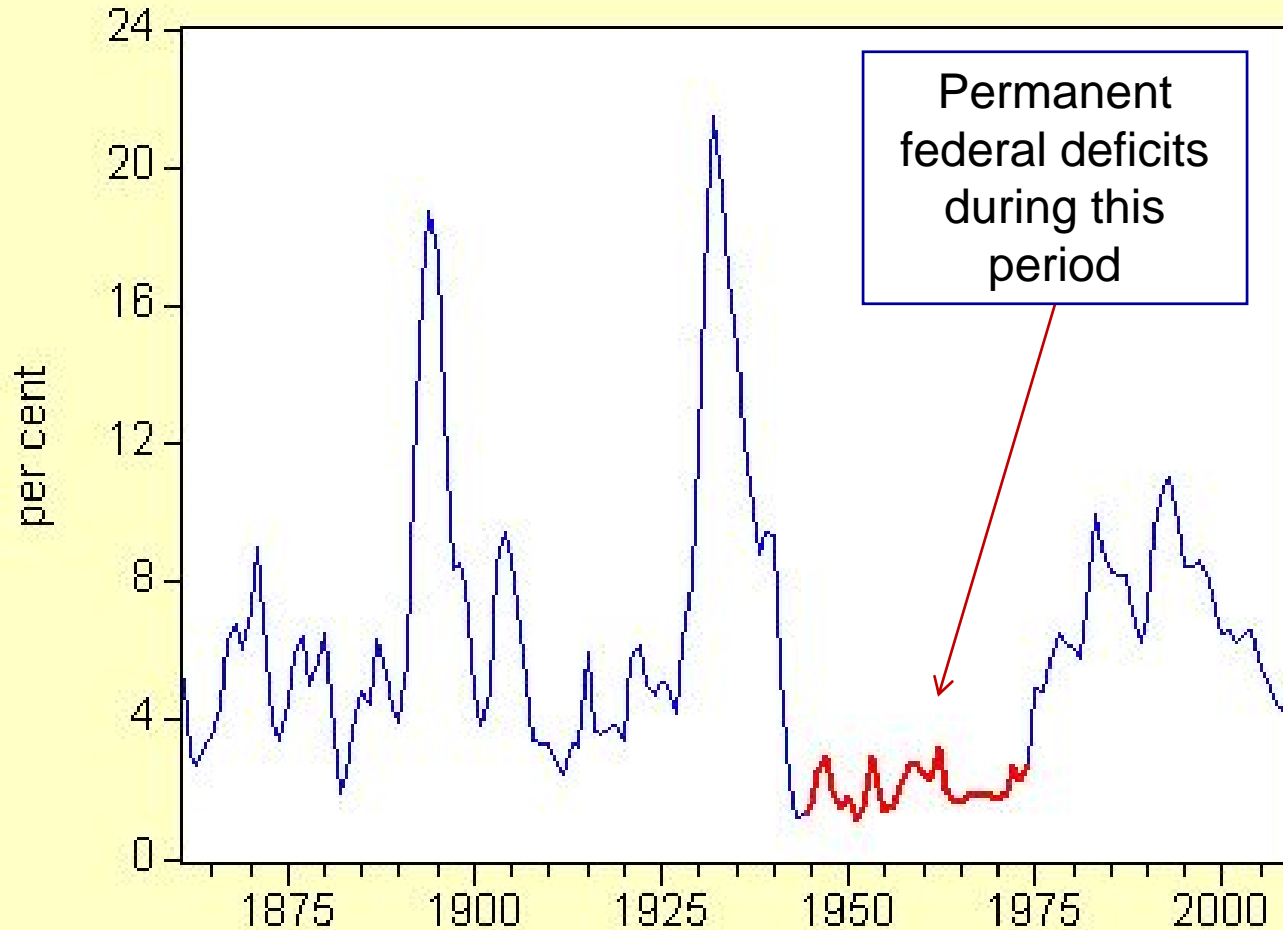
49% of jobs since 1978 are part-time and increasingly offering less than desired hours



# Australia: underemployment rising



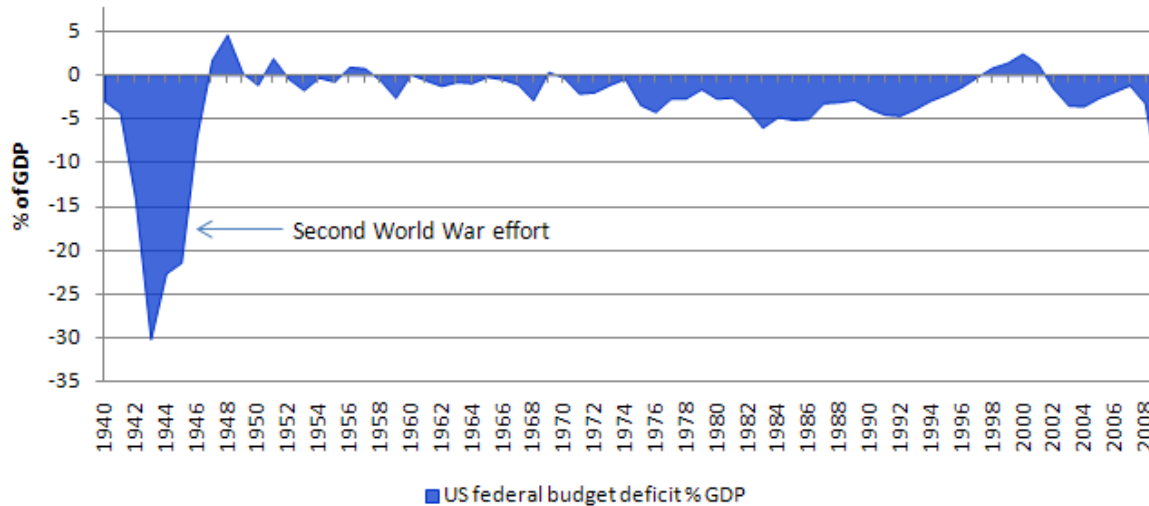
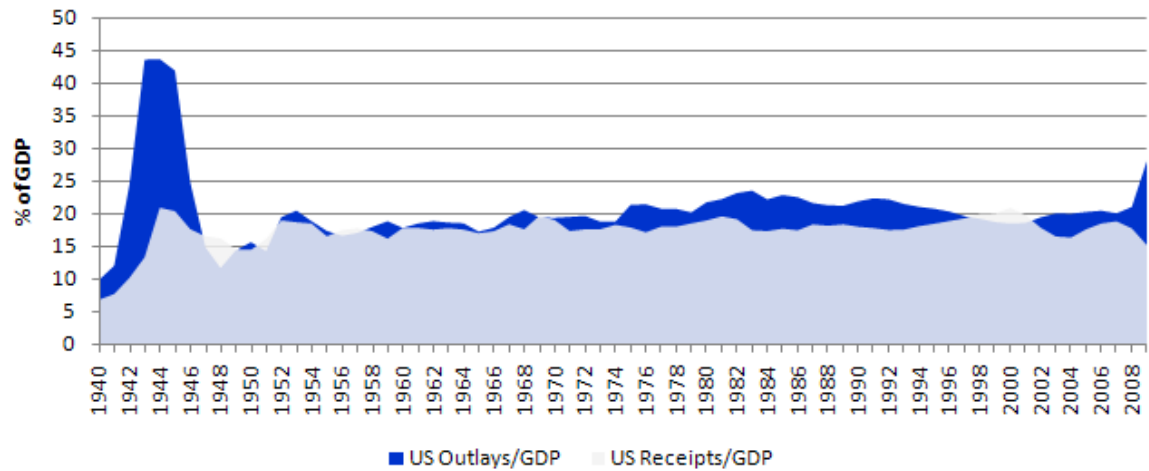
# Australia: historical perspective ... 1861 on



## What is full employment?

- Below 2% unemployment
- Underemployment = 0
- Hidden unemployment = 0

# US fiscal history since 1940 ...



# Fiscal sustainability ... what it is not!

- We won't find a definition of fiscal sustainability by drawing analogies with the household budget:
  - GBC - basis of mainstream thinking.
  - Flawed at most elemental level.
- The irrelevance of numerical ratios:
  - Budget deficit to GDP
  - Ratio of public debt to GDP
- The irrelevance of fiscal rules ...

# Where to start ...

- So where should we start in thinking about this concept?
- Why not start by defining why we bother with government in the first place.
- We want government to advance the well-being of the populace.
- We might call this the public purpose role of government.
- Dimensions?

# Advancement of public purpose

- The state should maximise the potential of its population.
- The sustainable goal should be the zero waste of people!
- This requires the state to maximise employment.
- Once the private sector has made its spending based on its expectations of the future, the government has to render those private decisions consistent with the objective of full employment.
- Non-government sector typically desires to save over the business cycle. What does this imply?

# Advancement of public purpose

- Non-government spending gaps over the course of the cycle can only be filled by the government.
- The national government always has a choice:
  - maintain full employment by ensuring there is no spending gap – that is run budget deficits commensurate with non-government surpluses; OR
  - maintain some slack in the economy (persistent unemployment and underemployment) which means that the government deficit will be somewhat smaller and perhaps even, for a time, a budget surplus will be possible.
- The **bad** versus **good** deficit – automatic stabilisers.

# Fiscal sustainability and full employment

- The automatic stabilisers ultimately close spending gaps because falling national income ensures that the leakages equal the injections – so sectoral balances hold.
- But the resulting deficits will be driven by a declining economy and rising unemployment.
- Fiscal sustainability is about running **good** deficits to achieve full employment **if** the circumstances require that.
- You cannot define fiscal sustainability independently of the real economy and what the other sectors are doing.



# Fiscal sustainability and full employment

- Once the link between full employment and the conduct of fiscal policy is abandoned, we are effectively admitting that we do not want government to take responsibility of full employment (and the equity advantages that accompany that end).
- That is why fiscal rules as stand-alone goals are meaningless or ideological.

# Understanding the monetary environment

- Any notion of fiscal sustainability has to be related to intrinsic nature of the monetary system that the government is operating within.
- It makes no sense to apply gold standard logic where the currency was convertible to another commodity of intrinsic value and exchange rates were fixed to a fiat currency system.
- So analysis that compares issues within the EMU or pegged currency nations to sovereign nations is pure misinformation – for example, Reinhart and Rogoff.

- Governments still apply **voluntary** constraints which have no intrinsic applicability to a sovereign government operating in a fiat monetary system
- These constraints are ideological and should be exposed as such.
- Fiscal sustainability does not require the national government issue any debt.
- In fact, debt-issuance has been seen as being intrinsic to the central bank's liquidity management operations – but that is even redundant.

# Understanding sovereign government?

- A national government in a **fiat monetary system** has specific capacities relating to the conduct of the sovereign currency.
- It is the only body that can issue this currency.
- It is a monopoly issuer, which means that the government can never be revenue-constrained in a technical sense (voluntary constraints ignored).
- This means exactly this – it can spend whenever it wants to and has no imperative to seek funds to facilitate the spending.

# Limits on government spending?

- The real question is what are the limits on government spending?
- While a sovereign government is not financially constrained it is nonetheless constrained in real terms.
- It can only buy what is available for sale.
- Unemployment is a sign that at least one resource is available for sale – basis of buffer stock policies – Job Guarantee.

# Understanding the nature of costs

- The numbers that appear in budget statements are not costs!
- The cost of a program are the extra real resources required for implementation.
- Persistently high unemployment means an abundance of underutilised real resources available – opportunity costs low.
- Fiscal sustainability would never be associated with underutilised labour resources – maximising human potential is the goal – maximising real utilisation rates.

# Understanding the role of taxation

- Will taxes rise when deficits rise?
- Possibly – but the rise has nothing to do with having to finance larger deficits.
- To understand what fiscal sustainability means we have to understand the role of taxation.
- Basis for demand of the currency.
- Effective counter-stabilisation tool.

# Fiscal rules and budget targets

- Any financial target for budget deficits or the public debt to GDP ratio can never be a sensible.
- The budget outcome is largely endogenous!
- It is highly unlikely that a government could actually hit some previously determined target if it wasn't consistent with the public purpose aims to create full capacity utilisation.
- Incompatible goals – external balances, private domestic balances and public balances.



# Structural budget balances ...

- How to assess the fiscal stance?
- Decomposing the budget – cyclical and structural components.
- Require “full employment” benchmark.
- NAIRU benchmark is not a true full employment benchmark.
- Assessments of fiscal position are always biased towards being too expansionary – which distorts policy choices.
- So there is in-built bias against the attainment of public purpose.

- The concept of fiscal sustainability is intrinsic to the ageing population – intergenerational debate.
- But not in the way that the public thinks about it.
- There is no **financial** crisis ahead with respect to increasing health care and pension entitlements.
- The government will always be able to afford to pay these bills.
- The actual issue is about real resource availability.
- By focusing on the financial we are undermining the real capacity to deliver these goods and services.

- Exports incur costs and imports bring benefits.
- Current account deficit mythology.
- Fear of depreciation.
- Foreigners do not fund the spending of a sovereign government.
- The concept of fiscal sustainability does not include any notion of foreign “financing” limits or foreign worries about a sovereign government’s solvency.

# The sovereign debt crisis

- Recall the need to understand the monetary framework.
- A country in the EMU is not like the US or Australia.
- A sovereign government is always solvent (unless it chooses for political reasons not to be!).
- The concept of fiscal sustainability is not defined in terms of any notion of public solvency.
- The concept of fiscal sustainability will not include any notion of financing imperatives that a sovereign government faces nor invoke the fallacious analogy between a household and the government.

# Sorting out the public debate ...



- The public debate is littered with statements that conflate political concepts with economic concepts.
- This conflation all but renders the economic content of the debate meaningless.
- Fiscal sustainability is about real economic goals.
- Governments should be brought to account on that basis.

# The way forward ...

- There is a need for a new macroeconomics narrative.
- A revised **macroeconomic narrative** can help us understand:
  - The operational features of the monetary system.
  - The opportunities each monetary system presents to the national government.
  - The ability of a sovereign government to maintain continuous full employment.
- We have to abandon the focus on financial matters and reorient the debate toward the real side of the economy.

- A new **macroeconomic narrative** is essential if the public is to be disabused of the myths that have been used to erode the collective will.
- Governments that abandon full employment and then punish the victims of this policy failure including low wage workers should not be supported.
- A fiscally responsible government aims to maximise the potential of all of its citizens.
- Public policy should always reflect that goal.

## billy blog

... alternative economic thinking

### More back to fiat monetary system basics!

June 23rd, 2009

Yesterday I reported on a document I received from one of the largest international investment banks in the world. That document is part of that organisation's advice it gives to bond investors. I used some of the document to illustrate that the understandings of how a modern monetary system operates that I write about here are also now out there in the real world - in the financial markets where bonds are bought and sold. I didn't identify the document because it is a subscribers-only publication sent to me by the author and I respect his privacy. Today's blog provides some more insights that will help you better understand the public debate and allow you to cut through the nonsense being peddled by all and sundry.

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### Credibility comes with understanding

June 22nd, 2009

I received a document today from one of the largest international investment banks in the world. One of its major offices is not far from where I am typing this right now in New York City. The document is a subscribers-only publication and so I cannot make it accessible here. But this blog discusses some of the contents of the document which might help readers who keep worrying about whether anyone important out there believes in the stuff that I write about. There is a constant undercurrent in the comments and private E-mails I receive that says that the treasurer, the central bank, the mainstream journalists and a host of



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My current state



June 2009

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[« May](#)



**Thank you**