

How do we pay for COVID19?

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Today's material expands on my two recent articles

‘COVID 19 package - helicopters to the rescue’,

<https://berl.co.nz/economic-insights/employment-and-skills-gdp-and-inflation-global-issues-government-and-fiscal>

and

‘Where to get the money? Just create it’ (*NZ Herald* 13 April 2020)

<http://www.geoffbertram.com/fileadmin/publications/Herald%20oped%2013%20April%202020%20scan%20and%20text.pdf>

The rhetoric of Austerity rules public debate

- ▶ Continual (electorally popular) tax cuts have made a large state sector unsustainable - “starving the beast” aka James O’Connor’s “fiscal crisis of the capitalist state”
- ▶ With tax revenues constrained and government shrunk accordingly, attempts to meet pressing collective needs by increasing government spending raise the prospect of fiscal deficits
- ▶ The austerity narrative then whips up public hostility to deficits in general
- ▶ The easy way to do this is to point out that deficits mean either increasing net government debt or “printing money”
- ▶ Debt is described as a “burden on future generations”
- ▶ Money printing is equated with hyperinflation
- ▶ Hence the media narrative about the Budget

Confusing Crown net worth with national economic strength (the new mercantilism).....

“Strong Govt books support ‘go hard, go early’ response”

(Grant Robertson press release March 31)

“Coming into this crisis New Zealand was fortunate to have a fundamentally strong economy and fiscal position... The Coalition Government had delivered on its plan to reduce net core Crown debt below 20 per cent of GDP and achieved \$12.8 billion of OBEGAL surpluses in our first two years in office... [T]his strong fiscal position, built on the work of Bill English and Michael Cullen, now means we are much better placed than many other countries to use our balance sheet to cushion the blow of COVID-19 on the economy and to protect the wellbeing of New Zealanders. The rainy day has arrived, but we are well prepared.

Many other countries are not starting from the same position of strength that we are. The UK started with net debt above 75%, the USA 90%, and Ireland 40%. Many countries are already well over 100% as they respond to the virus.”

Extracts from Budget speech May 14

.... leads to confusing a strong Crown balance sheet with fiscal space to increase spending

- ▶ The Minister of Finance claims that the strong Government balance sheet and low net debt are what has provided fiscal space for the expansionary 2020 Budget
- ▶ By “fiscal space” I understand “room to move” - ability to increase Government spending without hitting a constraint
- ▶ It’s COVID19, not the debt position, that has opened up fiscal space
 - ▶ In a fully-employed economy, government can expand only by reducing the private sector’s claim on resources (meaning higher taxes or bond sales)
 - ▶ In a deep recession resources lie idle => space for extra demand created already => no need to reduce private-sector demand using taxes or bond sales
- ▶ What matters is whether the macroeconomic situation is inflationary (≈full employment) or deflationary (≈below full employment)
- ▶ Govt net worth is irrelevant to fiscal space, and to provisioning for crisis
- ▶ The big mistake is to treat Core Government as just like a firm, or household, that can undertake extra spending only if they have cash or loan finance in hand
- ▶ Austerity narratives in Parliament and mainstream media repeatedly use that false analogy to justify slogans like “living within its means” and “burden of debt”
- ▶ Obsession with small state, budget surpluses and low debt have left fiscal space unoccupied over the past decade - unnecessary underfunding and unemployment

A sovereign currency-issuing Govt (= “Core Crown” in New Zealand public sector accounts) is not like a firm or household.

- ▶ Its spending does not have to be “financed” in advance in the same way as households’ or firms’ spending
- ▶ When it spends a dollar, that is newly-created money
- ▶ When it collects a dollar of tax revenue, or sells a dollar’s worth of bonds to the private sector, money is destroyed
- ▶ When Core Government runs a cash fiscal deficit, it increases the stock of money, and in the process increases the net wealth of the private sector, by placing in private hands an incremental set of claims on Government [= ability to pay taxes now or in future] in the form of money that can finance additional private spending
- ▶ Is a deficit associated with fiscal stimulus inflationary?
 - ▶ Under genuine full employment, potentially yes => tax increases or bond sales may be necessary to create fiscal space (or inflation itself can do the job)
 - ▶ In a depressed economy, no: fiscal space is already there; tax increases or bond sales tend to deepen the recession by further reducing private sector aggregate demand
- ▶ So in the present COVID downturn the Budget deficit can finance itself with no need for up-front funding from tax increases or bond sales to the private sector
- ▶ And no benefit on this front from past austerity and consequent balance-sheet entries
- ▶ (There are other reasons, though, to avoid overlarge government debt)

Important proviso: not all governments have monetary sovereignty in this sense

- ▶ Some parts of central government are like households or firms in that they require *ex ante* funding: SOEs, DHBs, etc.
- ▶ Governments or countries or territories that don't issue their own currency do not meet the conditions for monetary sovereignty: Euro zone countries like Greece and Italy, state governments in the USA and Australia, local government in NZ
- ▶ Countries with fixed exchange rates and open capital markets lack full control over their currencies because of the need for their central banks to defend the exchange rate
- ▶ The same applies to currencies on a full gold standard

Monetary sovereignty

All economies face real resource constraints, but full monetary sovereigns face no purely financial constraints (apart from self-imposed ones)

Four conditions of monetary sovereignty:

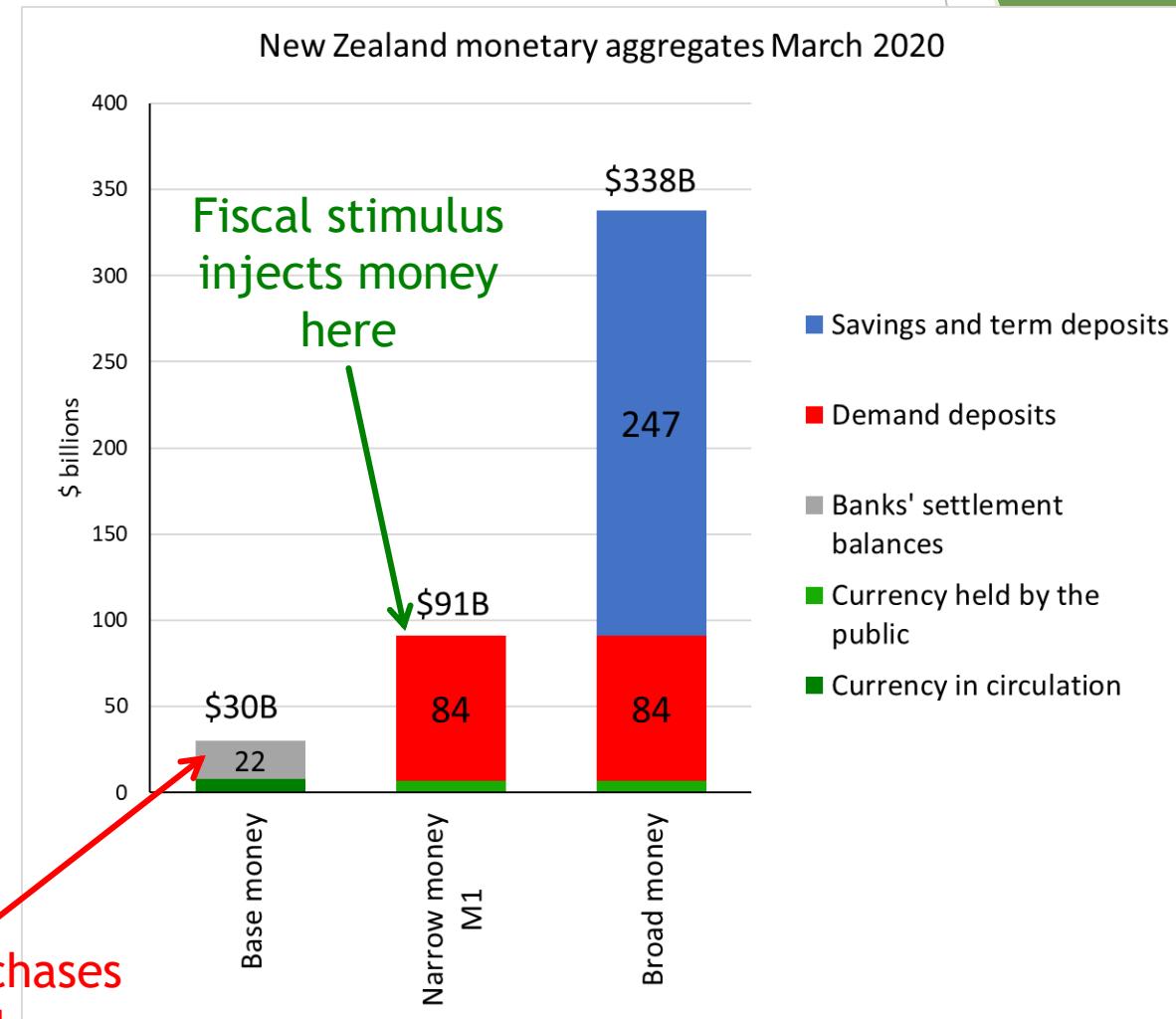
- ▶ Issue your own fiat currency and collect taxes in that currency 
- ▶ A floating exchange rate 
- ▶ No significant foreign-currency denominated government debt
(but keep an eye on private-sector overseas debt)
- ▶ Not dependent on imported necessities priced in foreign currencies

 Oil the obvious case

Money creation and destruction

- ▶ Base money is created by the central bank (RBNZ)
 - ▶ It comprises currency and banks' settlement balances with the RBNZ
 - ▶ RBNZ bond purchases inject cash into banks' settlement balances
- ▶ Treasury fiscal spending puts money created by RBNZ into private-sector recipients' pockets (currency) or their demand deposits
- ▶ Most narrow and broad money is created by the commercial banks when they make loans
 - ▶ It appears initially as increased demand deposits, which bank customers can draw down to fund spending, or hold as financial assets
- ▶ An increase in settlement balances enables, but does not guarantee, increased bank lending
- ▶ The demand for credit at the prevailing interest rate sets the limit to new lending
- ▶ Each new bank loan to private clients creates non-base money; each loan repayment destroys it
- ▶ Flows are continually changing all the stocks

RBNZ bond purchases
inject money here



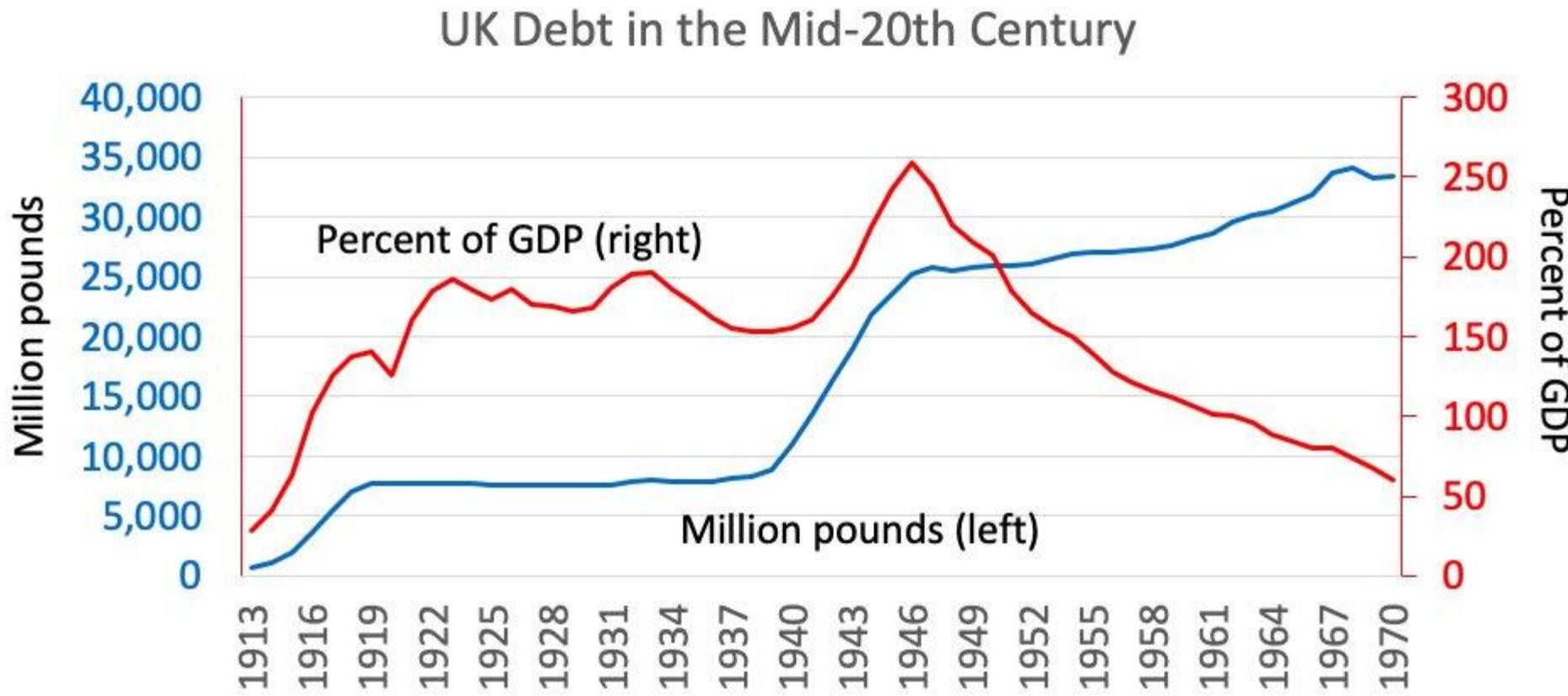
What “debt burden” ?

- ▶ Debt comes in many shapes. Some are burdensome. Others are not.
- ▶ When a firm or household borrows, it is bound to make future sacrifices to service and repay the debt. That can be a burden - or it can be a profitable win-win transaction
- ▶ When a country borrows from overseas lenders, its citizens are bound to make future collective sacrifices to service the debt obligation, which constitute a genuine burden if the borrowing does not increase future export earnings
- ▶ When a country borrows from itself, all that happens is that one group of citizens become creditors and the rest become debtors, with servicing and repayments flowing from the latter to the former. It's a matter of the distribution of wealth and income within the community - there is no aggregate “burden” in pure macro terms

So when is government debt a “burden”, and for whom?

- ▶ When the Core Crown (taxpayers as a group) borrows from the domestic private sector (rentiers as a group) this puts (to a first approximation) zero net aggregate burden on the NZ population as a whole. There's a burden on some and a matching gain for others.
 - ▶ Taxpayers pay interest and principle to rentiers: that's just a transfer from one group to another.
 - ▶ In mainstream macro models with a “representative agent” the two groups are the same individual so there is no burden
 - ▶ In the real world with heterogeneous agents, the mass of the people (taxpayers) pay the interest and principle and the rich (rentiers) receive those payments
 - ▶ But the borrowing is just deferred tax - so why not just raise tax rather than borrow when fiscal space has to be opened? [And when not, do neither].
- ▶ It's all about distributional outcomes and their consequences

And don't panic about 50-60% of GDP



Source: Bank of England

(I lifted this chart from Paul Krugman)

In summary

- ▶ Government borrowing in its own currency from the domestic private sector has in one sense the same macroeconomic effect as taxation: it reduces the aggregate private-sector claim on goods and services at the prevailing price level (that is, a reduction in aggregate demand)
- ▶ But in another sense the impact is different: tax reduces aggregate private wealth, borrowing leaves it intact
- ▶ And tax can be targeted whereas borrowing relies on the market to determine who ends up as creditors
- ▶ Unlike taxation, borrowing leaves a legacy of claims by the bondholders that have to be paid by taxpayers at large
- ▶ So government debt is in a sense just deferred taxation: the same amount of fiscal space can be created by either provided that borrowing reduces aggregate demand for currently-produced goods and services
- ▶ But obviously the rich would rather make loans to the state than pay taxes. Loans leave their wealth intact; taxes reduce their wealth.

Those distributional outcomes can matter

- ▶ Ongoing transfers from taxpayers to rentiers may not be in the long-run interest of society
- ▶ A state that uses debt rather than tax to create fiscal space for itself becomes increasingly a passive conduit for poor-to-rich transfers as distinct from an active agent in the economy
- ▶ This is a different idea of “debt burden” from the austerity narrative’s false threat of bankruptcy
- ▶ But it reinforces the long-run case for adequate taxation to sustain a social-democratic state

In sum, faced with COVID, does the government need to borrow from anyone but itself?

- ▶ Fiscal space has opened up big time.
- ▶ Aggregate demand is way down, deflation is in prospect
- ▶ So there is no need to cut private sector demand in order to leave room for government to put idle resources to work
- ▶ What is needed is the injection of additional aggregate demand, via
 - ▶ Direct government purchases of goods and services, and
 - ▶ Transfers of cash from government to private households and firms to enable them to purchase goods and services
- ▶ That process requires some money creation
- ▶ Right now there's no need for either tax increases or new debt (except 'debt' owed by Treasury to RBNZ)
- ▶ Issuing bonds to private buyers now just transfers wealth from taxpayers to rentiers

BUT...

- ▶ In future periods there may be an issue with excess liquidity (\approx aggregate demand $>$ aggregate supply), raising the prospect of inflation in the prices of goods and services and/or in the value of assets (houses etc). If and when that situation arises, there are (at least) five policy responses:
 - ▶ Increase tax to take excess aggregate demand out of the economy and relieve pressure on fiscal space
 - ▶ RBNZ sells its holdings of previously-issued bonds to take money out of the economy
 - ▶ Austerity: cut core Government spending to reverse the flow of new money into the economy and reduce aggregate demand
 - ▶ Allow inflation to run its course, reducing the value of currency and non-indexed bonds denominated in the currency
 - ▶ Limit credit creation by the banks (pull back broad money) by some rationing device - e.g., reserve ratio requirements
- ▶ Looking ahead, which of these is Treasury projecting in the 2020 Budget?

Answer: basically, austerity - Core Crown spending is to be dragged back to 30% of GDP by 2024:

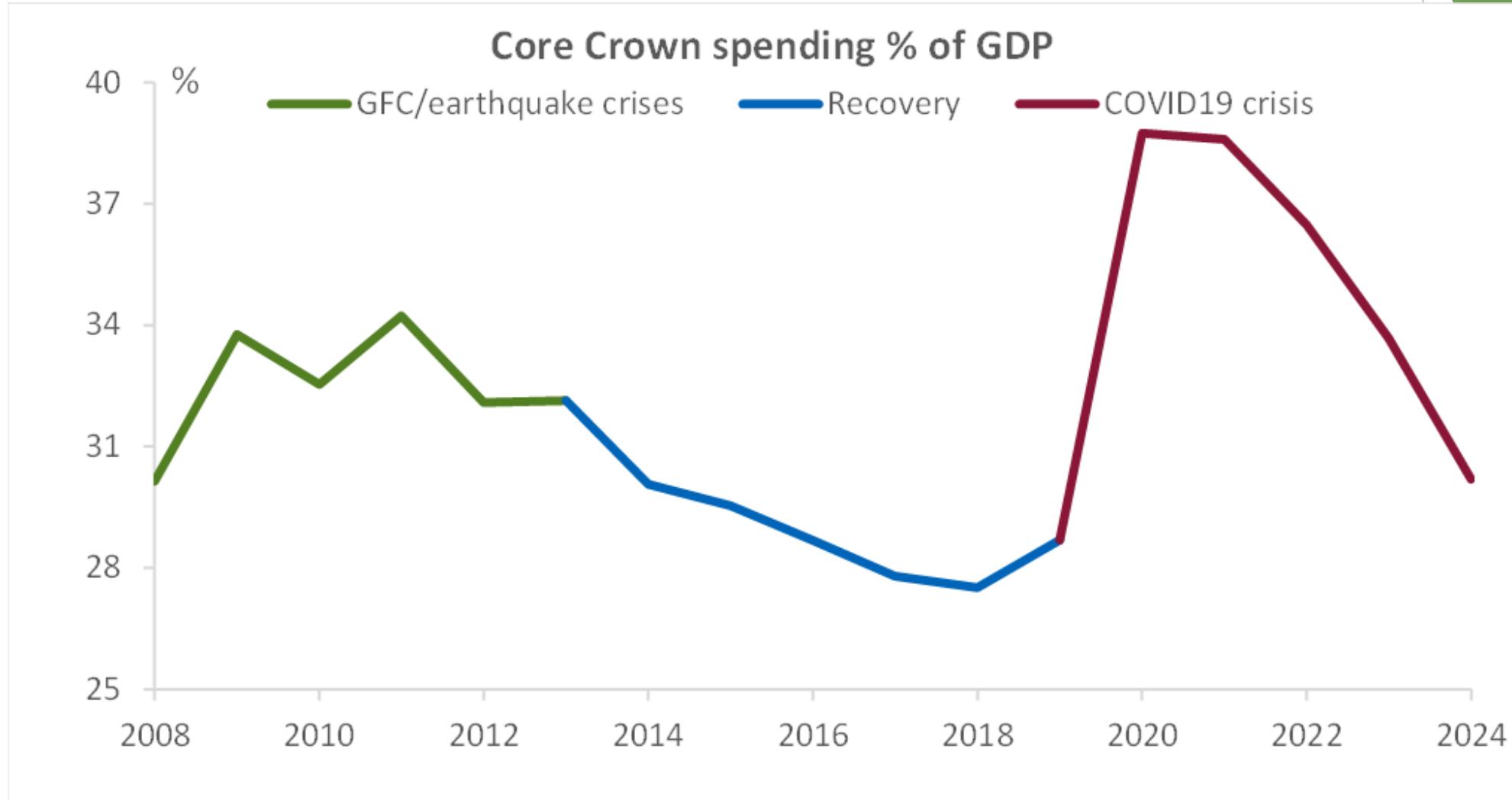


Chart produced by Ganesh Nana

In the longer run NZ needs to sustain a larger state sector

- ▶ That will mean a larger tax take as a proportion of GDP, to create the required fiscal space for government to command a bigger share of the economy's full-employment output
- ▶ If Government takes up a larger slice of the nation's output of goods and services, then the private sector has to give up some of its slice - that is the primary function of taxation once the economy has been pushed out to full employment
- ▶ A full-employment policy package therefore has to include a tax system designed to create and sustain the required fiscal space for government to do its job properly

What should we be looking for in 2024?

- ▶ My view: a larger share of GDP allocated to the state, to meet New Zealanders' collective needs in health, education, infrastructure, welfare...
- ▶ If the economy is by then at genuine full employment, that means that fiscal space will have to be expanded by increasing the tax take (either right away, or in deferred form via increased debt)
- ▶ In a progressive policy mix that tax issue should be addressed early rather than late - some package of
 - ▶ Taxes on wealth, inheritance and gifts
 - ▶ Carbon taxes (possibly funding renewables subsidies)
 - ▶ More progressive income tax scale
 - ▶ And so on.... [fill the blanks yourself]
- ▶ If we don't get ready for this before 2024, the austerity hawks will be ready with spending cuts (and tax cuts for the wealthy)
- ▶ Big takeaway: the case for operating deficits today is not a case for operating deficits tomorrow; the case against tax increases today does not carry over to the future; and the case for borrowing in future to dampen demand does not carry over to a case for borrowing today
- ▶ Tomorrow's policies need to be tailored to tomorrow's economic situation