

**ATTACHMENT 8 – PUBLIC AND PRIVATE PROVISION IN AUSTRALIA
(ACCESS ECONOMICS)**

Public and private pension provision in Australia

27 August 2009

Report by Access Economics Pty Limited for
Challenger Financial Services

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Executive Summary

Challenger Financial Services asked Access Economics to report on the cost of capital implications of alternative ways of addressing the problem of longevity risk for retirees.

Many retirees tend to take too much of their retirement income by way of lump sums and too little as annuities, and hence run down their capital ‘too early’. In part, that is due to:

- **Short-sightedness**, given that life expectancies have risen more than most recognise. The average man can expect to live about 9.4 years longer than his Dad, and the average woman some 7.1 years longer than her Mum.
- **The age pension**, which shifts some of the risks of running short later on in retirement back on to taxpayers by guaranteeing a minimum income.
- **Complexity**, with many retirees opting for simpler products rather than annuities in the face of financial fine print and difficult-to-understand investment choices.
- **Lack of choice**, with the range of products on offer here less than in some other nations.
- **Control of capital**, as retirees have shown a preference for retaining control of their own capital to cover any large unexpected costs such as a home renovation or ill health.

The market failure of short-sightedness and the fiscal blowback from longevity risks to public age pension costs point to the potential need for policy action. Accordingly, some observers argue there are major advantages in the Government providing longevity risk products: in effect, allowing or compelling people to buy ‘top up’ age pensions direct from the Government.

This is seen as having two key advantages:

- The Federal Government – and its AAA rating – has greater access to capital markets at lower costs than do private providers, providing buyers of these annuities with the equivalent of a ‘free lunch’.
- Proponents argue that Governments may also have access to economies of scale in administration and delivery not as readily available to private providers of pension products. (Others argue that this is unlikely to be material, given that the full cost of running an efficient life office is low, and scalable.)

This report assesses the first of the above two points. It finds that government provision of such products would indeed benefit buyers of these annuities.

It would not, however, benefit Australia as a whole.

Somebody pays

Why not? Because an iron rule of economics is that “somebody pays”.

Labelling borrowing as ‘public’ or ‘private’ does not change the inherent risk in the transaction, but only who bears that risk.

Hence the marginal transaction – paying upfront now for an income stream to follow – is the same regardless of whether done publicly or privately. That suggests that, over time, public provision would either draw directly on the Budget or tend to dilute the cost of capital advantage to public sector borrowing as a whole.

Consider two economies:

- One has zero net government debt, and all private borrowing is subject to the full risk inherent in its underlying economic activities.
- The second economy is identical to the first, with the exception of a blanket government guarantee on all debt transactions, funded through an efficient income taxation system.

The first economy faces credit defaults on occasion, which are absorbed as costs by creditors. It therefore must endure a higher (pre-tax) private cost of capital to cover those risks.

The second economy has no such defaults, as all credit risk is borne by the government. This economy enjoys a lower (pre-tax) private cost of capital. However, all taxpayers face higher costs and the level of economic activity is also constrained by that higher tax burden.

That example highlights the basic point that some of the costs of default risk can be covered by governments, but only at the cost of externalising the risks toward other parts of the economy.

That makes creditors happy (in this case the buyers of the government annuities), as they are facing reduced risk, but has wider consequences for all. However, the initial apparent ‘savings’ on interest payments are in fact matched by costs elsewhere in the economy over time – it is just that the savings are more obvious and the costs more diffuse.

If it was otherwise, then that would suggest a ‘free lunch’ available to all economies simply by re-branding some or all of their private debt as public debt. While there may be short run circumstances where re-branding might offer advantages, as a long run proposition it is dubious.

No free lunch?

Hence the basic view in this area is that labelling something as public rather than private borrowing simply shifts costs rather than eliminating them.

Yet there may be a potential caveat to that basic view. At the margin, if the world wants more Australian Government guaranteed debt than is currently on issue, then issuing more under this type of program would indeed offer a ‘free lunch’ of sorts to Australians if the Government were to borrow more in its own name (and the private sector less).

Moreover, given the currently limited supply of Australian Government backed debt, there may be an argument that there is a degree of excess demand for new issues of Commonwealth Government Securities (CGS).

However, if such a ‘free lunch’ is potentially on the table, there are other ways to eat it.

The Government could expand *gross* debt without lifting its *net* debt. This could be achieved by, for example, issuing debt in exchange for a portfolio of assets (similar to the existing Future Fund), or in exchange for matching debt from foreign governments.

This would expose taxpayers to greater financial risk, but would exploit the ‘good deal’ potentially available on CGS without the need for additional net debt.

Are today’s starting points for debt the issue – or tomorrow’s?

Moreover, there is a caveat on the above caveat. That is, even if markets have a degree of unmet thirst for Australian Government guaranteed debt as of today, there is less likely to be any such unmet demand in coming decades, when Government debt is projected to rise.

That is important because markets tend to be less forgiving of governments which already have higher debt ratios.

While Australia’s net public sector debt position is currently very strong relative to that of other developed nations, that strength is facing pressure in both the short and long term:

- Short term, the Federal Budget is in deficit, and is likely to remain so for some time.
- Longer term, the intergenerational pressures associated with an ageing population threaten to produce significant primary deficits over coming decades.

Moreover, the range of emergency measures adopted during the global financial crisis mean that the contingent liabilities on the Federal Government’s balance sheet have just ballooned.

The Federal Government’s debt is still set to remain very low by OECD standards. That said, and other things equal, the deterioration underway in the current and future creditworthiness of Australian Governments adds to the reasons to believe that there is no economy-wide ‘free lunch’ to be had in the Federal Government directly selling annuity products to Australians.

Borrower or guarantor?

As noted above, the Federal Government is in a good position to manage default risk, but that management comes at a cost.

That applies not only to the direct borrowings of the Federal Government, but also to any private borrowings sheltered under a government guarantee.

In turn, that raises the possibility of the key beneficiaries of a government guarantee (private borrowers and lenders) paying a fair price through a levy arrangement for the insurance provided by any such government guarantee.

Note that in the case of a universal guarantee, this would result in no change to the overall cost of capital in the economy – only a shifting of risk away from less creditworthy pursuits toward those with less inherent credit risk.

If the guarantee were less than universal, it would instead provide an effective subsidy to those borrowers covered by the guarantee at the expense of those without similar protection.

Given that, there may be a case for public sector guarantees for privately provided annuity products, with that public guarantee coming at a cost to the private provider – that is, a solution analogous to the current guarantee for bank and State borrowing.

In turn, that could be an option for the customer – that is, they could choose to buy a guaranteed or non-guaranteed product, and private providers could purchase guarantees to match the mix of demand they faced.

In sum

Australians do need to change the way they take their retirement incomes to match our rising life expectancies – less needs to come by way of lump sums, and more by way of annuitised income, with that combination helping to ensure that our retirees don't outlive their means.

How to achieve that?

There are obvious benefits for retirees if they can ride on the back of the Federal Government's ability to borrow cheaply.

However, any such good news for retirees from that quarter would be offset by rising costs to others. Labelling borrowing as 'public' or 'private' does not change the inherent risk in the transaction, but only who bears that risk.

Or, in other words, the initial apparent 'savings' would disappear over time – public annuity provision is more likely to, for example, either add marginally to the overall cost of public sector borrowing and/or add marginally to the overall cost of commercial bank borrowing used to finance Australian home and business loans.

Access Economics
27 August 2009

1 Introduction

This report:

- Examines the pros and cons of public rather than private provision of guaranteed income streams; and
- Looks at the potential impacts of compulsion in either case.

The focus is on the underlying economic concepts rather than detailed modelling of the outcome of any particular policy proposals.

Policies aimed at reducing retirees' longevity risk – the risk that they live longer than their retirement savings do – have drawn the attention of the Henry Review into *Australia's Future Tax System*.

Australians have traditionally shied away from retirement income streams which guarantee an income for life, and have instead preferred to access their super in a lump-sum.

In part, that preference is likely to be due to a combination of:

- **Short-sightedness**, given that life expectancies have risen more than most recognise. The average man can expect to live about 9.4 years longer than his Dad, and the average woman some 7.1 years longer than her Mum, yet average retirement ages have only been inching up. Many people may not realise the extra years in retirement that they will enjoy and the extra savings they will therefore need to set aside.
- **The age pension**, which shifts some of the risks of running short later on in retirement back on to taxpayers by guaranteeing retirees a minimum income. The potential for the age pension to act as a backstop against longevity risk would be expected to form part of any rational retirement plan. Reliance on the age pension backstop shifts longevity risk onto other taxpayers. Some of the longevity risk is also borne by family members who receive reduced inheritances.
- **Complexity**, with many retirees opting for simpler products rather than annuities in the face of financial fine print and difficult-to-understand investment choices. Retirees' desire to "keep things simple" is understandable¹.
- **Lack of choice**, with the range of products on offer in Australia less than that of some other countries.
- **Control of capital**, as retirees have shown a preference for retaining control of their own capital to cover any large unexpected costs such as a home renovation or ill health. In many cases, control of capital is also important for estate planning, and so that retirees can maintain links with their children for as long as possible².

¹ There is a discussion on this point in the RBA Financial Stability Review, March 2009.

² B.D. Bernheim, R.J. Lemke, J.K. Scholz, "Do Estate and Gift Taxes Affect the Timing of Private Transfers?" (p3), NBER 2003.

Of the five reasons given above for why Australians might avoid annuities, only the first reason is a pure “market failure” – short-sighted expectations. With life expectancies continuing to rise, there is a growing risk that individual retirees spend their super savings too quickly and that more generally Australians fail to plan effectively for their later retirement years, relying on the age pension to support them later in life when their super is gone. If individuals underestimate their retirement years, but fund providers have an accurate (and higher) estimate of retirement years, then commercially offered annuities would be expected to struggle in the market place for want of customers. Evidence of such market failures would suggest that there might be a case for a corrective policy intervention.

The second reason – the potential for age pension costs to blow out – is not a market failure per se. However, it also offers a fiscal rationale for why the Federal Government might also want to consider a policy intervention.

The dual rationales of short-sightedness and fiscal protection underpin current retirement incomes policies. If these rationales were considered strong enough to justify further policy intervention so as to internalise some longevity risk to retirees, then the policy intervention could take a number of forms.

Two ‘polar’ approaches are possible – one simple, one ambitious:

- *First*, retirees could be required to use part of their super payout to buy a guaranteed income stream from a pension provider. As with the 9% SG, this would aim to overcome short-sightedness and provide a larger pool of investment funds to control costs and promote innovation in pension products. The Government’s role here could be as ‘simple’ as passing legislation.
- *Second*, an alternative approach (a version of which may be considered by the Henry Review) would be to allow retirees to ‘buy’ a guaranteed income from the Government, either using their super payout, or by staying on in the workforce for longer (and hence providing a boost to the economy, and to tax revenues). The Government’s role here could be expansive – for example, the Government could act as a full service provider by offering retirement financial planning advice, collecting and investing retiree’s investment funds and providing annuities. Private sector involvement could be zero.

There are obviously a range of sub-options that might be considered between these two polar proposals.

However, rather than consider detailed options for potential implementation, the focus of this report is to address the public sector cost of capital proposition which has been put forward in support of public annuity provision.

This proposition argues that Government can borrow at a lower cost than the private sector.

If the proposition is true, then that will affect the design of any proposal that aims to address longevity risk.

2 The current system

It is useful to distinguish between **individual longevity risk** and **systemic longevity risk**:

- For **individuals**, the risk is that they outlive their planned life expectancy, and hence their financial means. This risk can be eliminated by individual retirees banding together in a funding scheme where fund outflows (that is, retirees' annuities) are covered (in net present value terms) by fund inflows (retirees' contribution to the fund). Individual retirees are unlikely to live the precise average life expectancy – those living longer than the average will benefit from a lifetime annuity at the expense of those living shorter than the average. Longevity risk – both upside and downside – is therefore shared between the scheme's retirees.
- For **governments and private pension providers**, the risk is that the 'whole population' life expectancy or fund investment returns will change in an unexpected way. If the size of the fund pool is insufficient to pay fund outflows, then the annuities scheme will collapse without outside support or a change in the terms of the fund. Such a systemic risk could result for example from unexpectedly rising life expectancies or lower than expected long term rates of return from the fund's investments.

The Government provides an age pension, which it boosted further in the Federal Budget:

- This provides a degree of cover for longevity risk for individuals, though the retirement income adequacy of the pension by itself is low.
- Lower adequacy and higher pension reliance will persist while the superannuation system is immature and/or while super incentives fall short of encouraging adequacy for specific groups.
- Hence the age pension of itself is not sufficient to meet the demand for longevity risk products in Australia.

Yet the private provision of retirement income products is patchy, as the Henry Review has noted in its interim report on retirement incomes:

“The market in Australia for products that provide either a lifetime, or deferred income stream is not as developed as in some other countries”

“Better retirement income products should be available for purchase so a person can ensure an income higher than the Age Pension throughout their retirement”

Australia's future tax system – The retirement income system: Report on strategic issues

2.1 Current system – the Government age pension and its effect on private provision

While not universal, the Government age pension (including part pensions) casts a wide net:

- Access Economics longer term modelling indicates that many people – including many well off people – will eventually qualify for part pension, while those who don't are not a particular public policy concern.
 - Even 'more attractive' annuity products may not be attractive to this group, as their asset base and income flows are likely to cover both their longevity risk and bequest motives regardless of their individual longevity outcomes.
- The age pension does comprehensively insure against longevity risk, but at a low income replacement rate for most, and in a manner which encourages the shifting of the risk burden to the government, all the more so to the extent people are short-sighted as to their life expectancy.

That said, there are features of the age pension which make it an attractive backstop against the risk of living longer than expected:

- The pension is indexed to CPI inflation, and maintained at a minimum ratio to Male Total Average Weekly Earnings (MTAWE), meaning its real value will increase over time.
- The longer one lives, the lower one's capacity may be to enjoy spending. A number of studies – both here in Australia and overseas – have shown that discretionary spending declines over the later years of retirement. At the same time, those areas where costs increase with age, such as health and aged care, are largely covered by government services. That is likely to mean a lower retirement income 'adequacy' threshold for those who do outlive their peers.

3 Public sector provision and the cost of capital

Part of the Henry Review discussion on longevity risk focuses on the private versus public provision of annuities.

The Review rightly identifies the Federal Government as Australia’s main provider of longevity insurance through the age pension.

Does that mean that the Government may also be able to offset the risks inherent in offering an income guarantee more effectively than the private sector (especially if the Government has to insure private sector guarantees)?

Such a possibility partly revolves on the stronger ability of the Government to pool risks, aided by its lower cost of capital compared to the private sector.

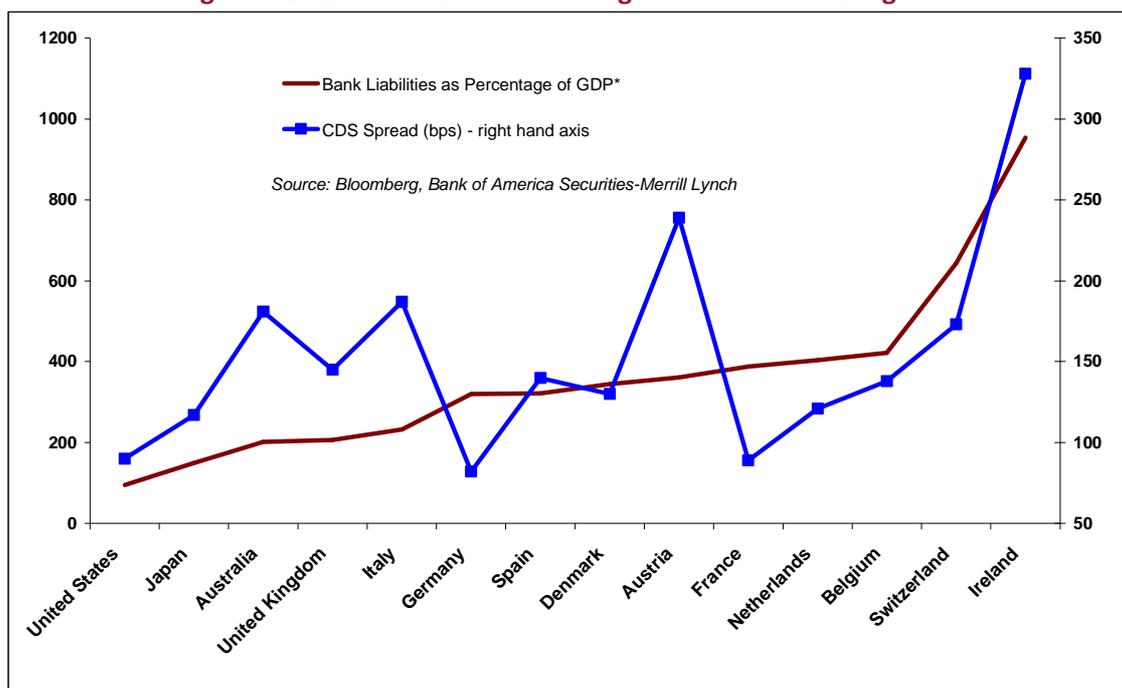
This section examines both the financial and economic costs of public sector borrowing, noting that:

- If markets are well informed, the cost of capital advantage enjoyed by governments is likely to be eroded as more borrowing increases the risk attaching to government debt.
- Even if markets do not fully adjust, the resulting risks are then passed to taxpayers – as higher taxes or lower spending if governments are forced to default debt.

3.1 Public borrowing and the cost of capital

Governments cannot borrow forever without paying a cost penalty.

Figure 3.1: Links between borrowing levels and borrowing costs



While governments in general enjoy low borrowing costs, those with greater levels of debt are considered at greater risk of default – and must pay higher borrowing costs as a result.

The chart above shows the size of national banking systems relative to national income, and matches that against the assessment being made in markets of the likelihood of default.

It is an illustration of the links between borrowing levels and borrowing costs – a linkage which is also important for governments, not just private sector borrowers.

Eventually, taking on additional debt will lead markets to rethink their assessment of a Government's financial position:

- That is more likely to be true when the government is borrowing to finance investments in business assets (rather than borrowing to smooth the impact on tax revenues and expenses through the business cycle, or borrowing to fund infrastructure which will provide long term benefits to taxpayers).
- Markets tend to hold the view that government activities are better risks than business activities.
- However, when governments borrow in order to fund the purchase of business assets (as would be the case for a public annuity offering), then that view is diluted.
- Sophisticated markets are able to look through the public sector 'label' placed on borrowing to the assets underneath, attaching similar levels of risk to those for private borrowers.

Governments which borrow to fund public sector investment in more risky assets are, other things equal, likely to be subject to higher borrowing costs.

A shift in the mix of services funded by borrowing can therefore influence the level of risk – both real and perceived.

Importantly, any resulting increase in borrowing costs would apply across the entire stock of existing government debt, meaning that a small change in the market's assessment of risk might translate into a larger impact on overall borrowing costs.

In the case of public annuity provision, the marginal transaction would be the same regardless of whether it was done publicly or privately.

That suggests that, over time, public provision would either draw directly on the Budget or tend to dilute the cost of capital advantage to public sector borrowing as a whole.

That raises the possibility that increased borrowing costs on all Government debt would offset the borrowing cost advantage on new debt – effectively negating the cost of capital advantage of public provision.

If it was otherwise, then that would suggest a 'free lunch' available to all economies simply by re-branding some or all of their private debt as public debt.

While there may be short run circumstances where re-branding might offer advantages, as a long run proposition it is dubious.

The global financial crisis helped to show that ‘hiding’ the ultimate owners of debt in order to gain a ‘lower’ cost of capital is not sustainable and ultimately damaging – it was sub-prime home owners regardless.

That means **debt sustainability matters** and that governments cannot borrow in a manner which steadily increases overall leverage in perpetuity.

Doing so would threaten fiscal sustainability, and hence external stability, the government’s credit rating and the cost of credit.

The Federal Government recently implemented a number of measures aimed at maintaining stability and confidence in the financial sector. Three of these measures are examined here. They all focus on Australian Government guarantees aimed at ensuring the continued flow of funding for particular purposes (and incidentally provide potential funding models for a government guarantee of private pensions). In two of these measures, these guarantees have come with an explicit “price” of a fee premium based on the credit rating of the borrower.

First, there is a guarantee for deposits and for wholesale debt securities issued by authorised deposit-taking institutions (Table 4.1).

Table 3.1: Deposit and wholesale funding guarantee

| Credit Rating | Debt Issues Up to 60 Months |
|----------------------|------------------------------------|
| AA | 70bp |
| A | 100bp |
| BBB and Unrated | 150bp |

Source: The Treasurer, 24 October 2008.

Second, the Federal Government has also provided guarantees of State debt with the price of the guarantee rising both with a lower credit rating and with new (or marginal) borrowing (Table 4.2).

Table 3.2: Guarantee of State and Territory borrowing

| Credit Rating | Fee (existing stock) | Fee (new issuance) |
|----------------------|-----------------------------|---------------------------|
| AAA | 15 basis points | 30 basis points |
| AA+ | 20 basis points | 35 basis points |

Source: The Treasurer, 12 May 2009.

Third, the Government also established a special purpose vehicle (SPV) to help provide wholesale financing to those motor vehicle dealers financed by two private financiers which exited the Australian market as a result of the global financial crisis. The SPV was established as a financing trust, with the joint support of the Government and the four largest Australian banks, to provide liquidity to car dealer financiers through the securitisation of eligible loans provided to car dealers. The expectation was that the SPV could be required for up to a year³.

There are differing views on when these measures will terminate, though the RBA clearly sees the first guarantee as a temporary response to the global financial crisis (see Appendix B).

³ RBA, Financial Stability Review, March 2009.

In setting the premiums on the bank guarantee the Government considered a range of factors. In particular:

“the premiums were set at a level that was between the then current market price – which was viewed as the product of very stressed conditions – and the price that was thought likely to prevail when more normal market conditions returned.”

If the premium is set too low then that would have encouraged “moral hazard” from banks – that is, they could borrow at a funding advantage where taxpayers wore the risk. In the current crisis, the Government set the premiums in recognition of the temporary market imperfections caused by “very stressed [financial] conditions”.

Such an approach has been supported on other occasions by a number of academic papers which state that, in the absence of market imperfections, the cost of capital for public projects should be the same as the cost of capital for comparably risky private ventures⁴.

There are hints that the premiums in Table 3.1 may be too low. The RBA Governor Glenn Stevens recently chided Australian banks for having been responsible for 10% of the entire world’s issuance of government-guaranteed bank debt over the past nine months (Appendix B). It is also evident in his comments:

“But the longer-term question is whether ... we would really want to keep moving in the direction of a world where the bulk of debt is government-issued or government-guaranteed. It seems to me that that could easily be a world in which investors end up being no more discerning about risk and return than the buyers of [collateralised debt obligations] a few years ago, and in which banks themselves ultimately rely on the guarantees to an inappropriate or even dangerous extent.”

The three measures mentioned above are of interest because they provide potential funding models for guaranteeing private pensions and provide examples of current Australian Government thinking in this area. The first and third models indicate very different levels of Australian Government involvement:

- The first – the deposit and wholesale funding guarantees provided to the banks – represents a minimalist approach from the Australian Government where the funding is channelled through existing private agents which pay a fee for the guarantee. This relatively hands-off role from the Australian Government is facilitated by the fact that these private agents are already closely regulated by APRA (just as providers of guaranteed lifetime annuities are subject to prudential regulation).
- The SPV approach has the Australian Government playing a stronger hands-on role in ensuring adequate funding (for car dealerships). A more hands-on role from the Government was probably needed because foreign-owned car dealership financiers were relatively unregulated, so a replacement financing vehicle needed to be built within the Government tent and a few highly supervised private players.

There would seem to be two messages here.

⁴ See for example, the research noted by Grant S and Quiggin J (2001) *Public investment and the risk premium for equity*, <http://www.uq.edu.au/economics/johnquiggin/JournalArticles03/EPEconomica03.pdf>.

First, if the Australian Government was to provide funding support in the form of guarantees for providers of private annuities then it would likely insist on maintaining very close supervision of private industry. That said, the existing supervision of this sector is already notable – a factor which has hampered the annuity market in Australia in the past (including high effective reserve ratios). If the Australian Government felt that current very close regulation was less desirable for some reason, then the Government might consider an alternative funding model where it took on the risk, but it minimised private sector involvement.

Second, industry could also expect to pay a premium that reflected the borrowing advantage that the Australian Government has as a result of its credit rating.

That said, for now the increased borrowing already announced by the Federal Government is unlikely to threaten the immediate sustainability or Australia's credit rating.

Adding the debt for other levels of government to the Federal debt, total government net borrowing rises to about 14.2% of GDP, which is below the 21.7% median AAA estimate published by Standard & Poor's (S&P) in February 2009.

Are the official estimates of the Commonwealth debt path likely to be accurate?

In one sense the debate over Federal Government debt projections is academic – debt will keep rising while deficits continue to linger, and the difficulty of substantially reining in spending in coming years suggests that there is a risk that the latter linger for longer than the official forecasts allow.

That said, some perspective is useful here.

There is the potential for net debt in Australia to move rather higher than the official forecasts allow. While that would still be rather smaller as a share of GDP than in most other developed countries (for example, the IMF predicts 80% net debt for countries such as the US, UK, Germany and France by 2014), the discussion in Section 3.4 below notes that there would be problems were Australia's net debt ratio to go over 60%.

3.2 Potential economic costs of increased public borrowing

An iron rule of economies is that "somebody pays".

Labelling as 'public' or 'private' borrowing does not change the inherent risk in the transaction, but only who bears that risk. Some of the costs of default risk can be covered by governments, but only at the cost of imposing those risks on other parts of the economy.

That makes creditors happy, as they are facing reduced risk, but it also has wider consequences.

To see this, it is useful to consider why markets show a strong preference for government debt over private borrowing.

The key reason behind that preference is a simple one – governments are generally seen as less likely to default on repayment of a loan than corporations.

That is because governments have unique advantages when it comes to avoiding default: they can force taxpayers to bear the costs of repaying a loan in the event of financial trouble.

Both of the above involve passing on some or all of the costs of repaying debt to taxpayers. Governments enjoy superior credit ratings to private firms in part because they have the ability to pass on the cost of servicing that debt to taxpayers.

Assuming taxpayers have the capacity to pay back debt, credit markets are not concerned by any potential costs associated with higher taxes, or reduced government spending. Such a transfer of costs is a key benefit for debt investors, who are only interested in recovering their money.

It does, however, come at a price – lower living standards for taxpayers and collateral damage to the economy as higher taxes discourage investment and workforce participation.

Indeed, to the extent that these external costs are not considered by ratings agencies, they reflect a key difference between the cost of capital as measured by the market, and the true ‘social’ cost of capital in the economy as a whole.

Where credit markets do not fully adjust to reflect the new state of government finances, this potential for ‘collateral damage’ (which is not reflected in borrowing costs as measured by credit markets) is making up the difference.

Or, in other words, any initial and apparent ‘savings’ on interest payments are likely to be matched by costs elsewhere in the economy over time.

Consider two economies:

- One has zero net government debt, and all private sector borrowings are subject to the full risk inherent in their underlying economic activities.
- The second economy is identical to the first, with the exception of a blanket government guarantee on all debt transactions, funded through a relatively efficient income taxation system.

The first economy faces credit defaults on occasion, which are absorbed as costs by creditors.

It therefore must endure a higher (pre-tax) private cost of capital to cover those risks.

The second economy has no such defaults, as all credit risk is borne by the government. This economy enjoys a lower (pre-tax) private cost of capital. Instead, all taxpayers face higher costs and the level of economic activity is also constrained by a higher tax burden.

The above example highlights the basic point that some of the costs of default risk can be covered by governments, but only at the cost of externalising the risks toward other parts of the economy. Creditors face reduced risk, but at the cost of wider consequences for all.

3.3 Is there a free lunch for the economy as a whole?

Hence the basic view in this area is that labelling something as public rather than private borrowing simply shifts costs rather than eliminating them.

Yet there may be a potential caveat to that basic view. If the world wants more Australian Government guaranteed debt than is currently on issue, then issuing more under this type of program would indeed offer a ‘free lunch’ of sorts to Australians if the Government were to borrow more in its own name (and the private sector less).

Markets like public debt – often with good reason. Even in the case of a serious default, governments have a habit of surviving. While companies disappear after defaulting on debts, governments often return to financial health and therefore to bond markets. This gives rise to ‘repeated game’ scenario – ensuring governments think much more seriously about default than companies do.

Moreover, given the currently limited supply of Australian Government backed debt, there may be an argument that there is a degree of excess demand for new issues of Commonwealth Government Securities (CGS).

However, if such a ‘free lunch’ is potentially on the table, there are other ways to eat it.

The Government could expand *gross* debt without lifting its *net* debt. This could be achieved by, for example, issuing debt in exchange for a portfolio of assets (similar to the existing Future Fund), or in exchange for matching debt from foreign governments.

This would expose taxpayers to greater financial risk, but would exploit the ‘good deal’ potentially available on CGS without the need for additional net debt.

Indeed, we may already be enjoying some of the benefits of this ‘free lunch’, as any excess demand would depress the cost of the existing CGS market – an advantage which would be diluted by new issuance.

3.4 What level of debt is sustainable?

It is clear that governments cannot borrow in perpetuity without affecting their long term fiscal sustainability.

As noted in the Federal Government’s *2007 Intergenerational Report*, accumulating debt is not a sustainable long-term solution, particularly in situations where budget deficits are expected to continue for a period of time, since at some point the debt needs to be repaid. In addition, the compounding effect of interest costs would see net debt rise very rapidly.

The IMF and World Bank have conducted extensive research into what level of debt is generally seen as sustainable.⁵ They conclude that, irrespective of what probability of debt distress is considered tolerable, the empirical evidence suggests that debt thresholds should be established in light of the quality of a country’s policies and institutions.

Table 3.3 presents this as an operational matrix, defining indicative policy-dependent debt limits based on the (rounded) results of Bank and Fund staff’s empirical analyses.

⁵ IMF and World Bank (2004) Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications, <http://www.imf.org/external/np/pdr/sustain/2004/020304.htm>.

While these thresholds are only indicative, they nevertheless provide a useful tool to indicate the point after which debt distress is more likely to eventuate. These limits are seen to provide a useful basis to guide future borrowing (and lending) decisions – perhaps with a conservative bias, given that the underlying NPV data in the empirical analyses are derived on the basis of historical discount rates.

It suggests that, for a country like Australia with strong institutions, a government debt in excess of 60% may become a worry in terms of sustainability.

- The IMF further recently commented that Australia is susceptible to downside risks such as falls in commodity prices, especially due to its relatively high level of external liabilities. By end 2008 net foreign liabilities for Australia were over 60% of income – though this includes private as well as public sector debt.⁶

Table 3.3: Indicative policy-dependent debt and debt-service thresholds (in %)

| | Assessment of Institutional Strength and Quality of Policies | | |
|---------------------------|--|--------|--------|
| | Poor | Medium | Strong |
| NPV of debt-to-GDP | 30 | 45 | 60 |
| NPV of debt-to-exports | 100 | 200 | 300 |
| NPV of debt-to-revenue | 150 | 200 | 250 |
| Debt service-to-exports | 15 | 25 | 35 |
| Debt service-to-revenue | 20 | 30 | 40 |

Source: IMF and World Bank (2004).

3.5 Starting points for public finances

Given the discussion above, it is worthwhile examining the direct and indirect debt profile of the government as well as the broader costs of borrowing.

That is because there is a ‘caveat on the above caveat’. That is, even if markets have a degree of unmet thirst for Australian Government guaranteed debt as of today, there is less likely to be any such unmet demand in coming decades.

That is important because markets tend to be less forgiving of governments which already have higher debt ratios.

While Australia’s net public sector debt position is currently very strong relative to that of other developed nations, that strength is facing considerable pressure in both the short and long term:

- Short term, the Federal Budget is in deficit, and is likely to remain so for some time.
- Longer term, the intergenerational pressures associated with an ageing population threaten to produce significant primary deficits over coming decades.

⁶ IMF (2009) World Economic Outlook (WEO) - Crisis and Recovery, April 2009, <http://www.imf.org/external/pubs/ft/weo/2009/01/index.htm>.

Moreover, the range of emergency measures adopted during the global financial crisis mean that the contingent liabilities on the Federal Government's balance sheet have just ballooned.

Other things equal, the deterioration now underway in the current and future creditworthiness of Australian Governments adds to the reasons to believe that there is no economy-wide 'free lunch' to be had in the Federal Government directly selling annuity products to Australians.

3.5.1 Direct debt

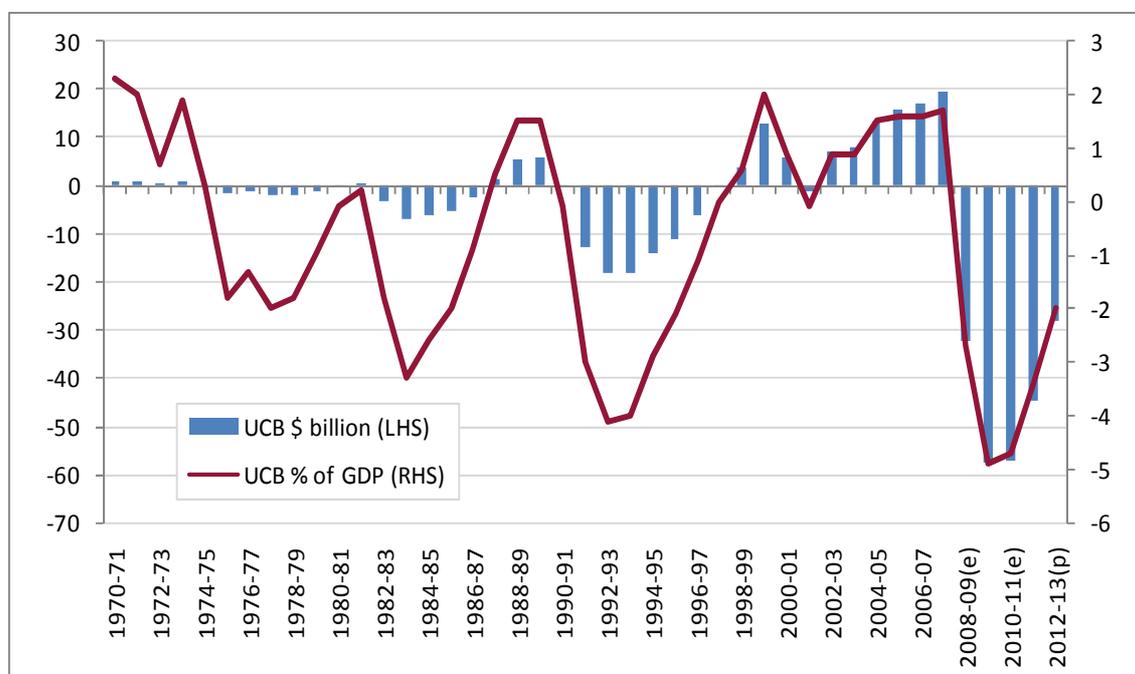
The 2009-10 Budget highlighted a marked turnaround in Federal Government finances:

- The 2008-09 Budget forecast underlying cash surpluses of around \$80 billion from 2008-09 to 2011-12.
- In contrast, this Budget predicts deficits totalling \$191 billion over the same period – a turnaround of \$270 billion. The deficit for 2009-10 is \$57.6 billion or 4.9% of GDP, larger than the previous peak of 4.1% in 1992-93 (and the peaks in the 1970s and 1980s).

As the global financial crisis hit in late 2008, government revenues were greatly reduced while there was more call on government spending – both through automatic stabilisers (such as more unemployment benefits) and through discretionary spending which aimed to prop up falling private economic activity.

The deterioration in revenue means that the Government is now borrowing notably.

Figure 3.2: Official forecasts of the underlying cash Budget (UCB) balance

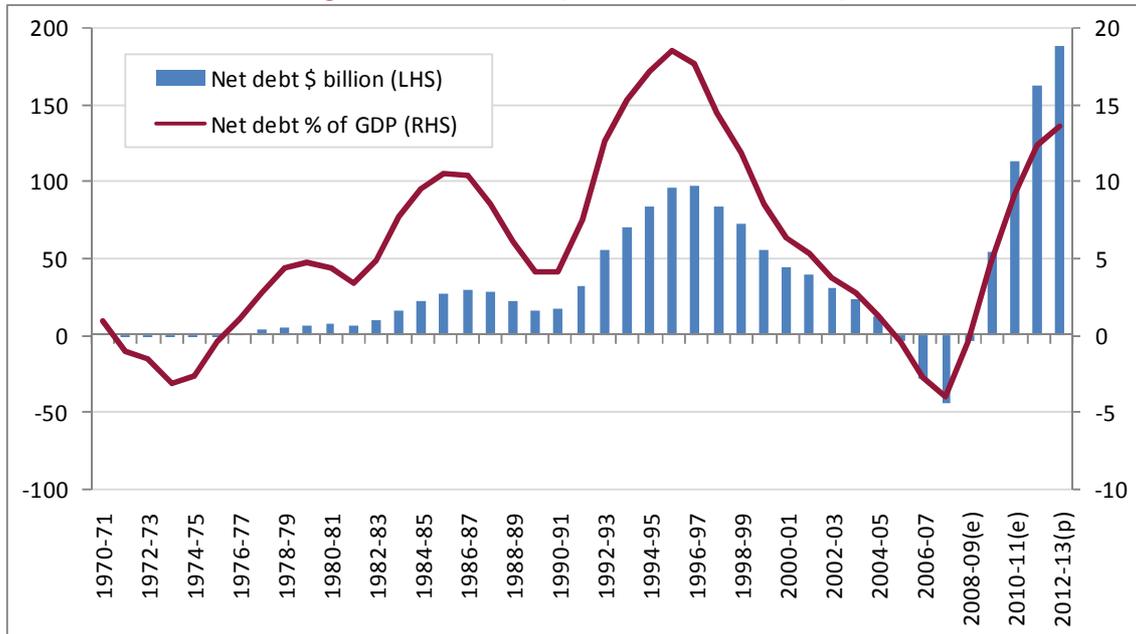


Source: Commonwealth 2009-10 Budget Paper 1, Statement 10.

The result is borne out in Figure 3.3, which sees net debt at \$188.2 billion or 13.6% of GDP by 2012-13. (Since the Budget the Government has noted it estimates net debt to return to zero

by 2022.) The total stock of Commonwealth Government Securities (CGS) on issue at 30 June 2010 is projected to be \$169.9 billion, an increase of \$58.0 billion on 30 June 2009.

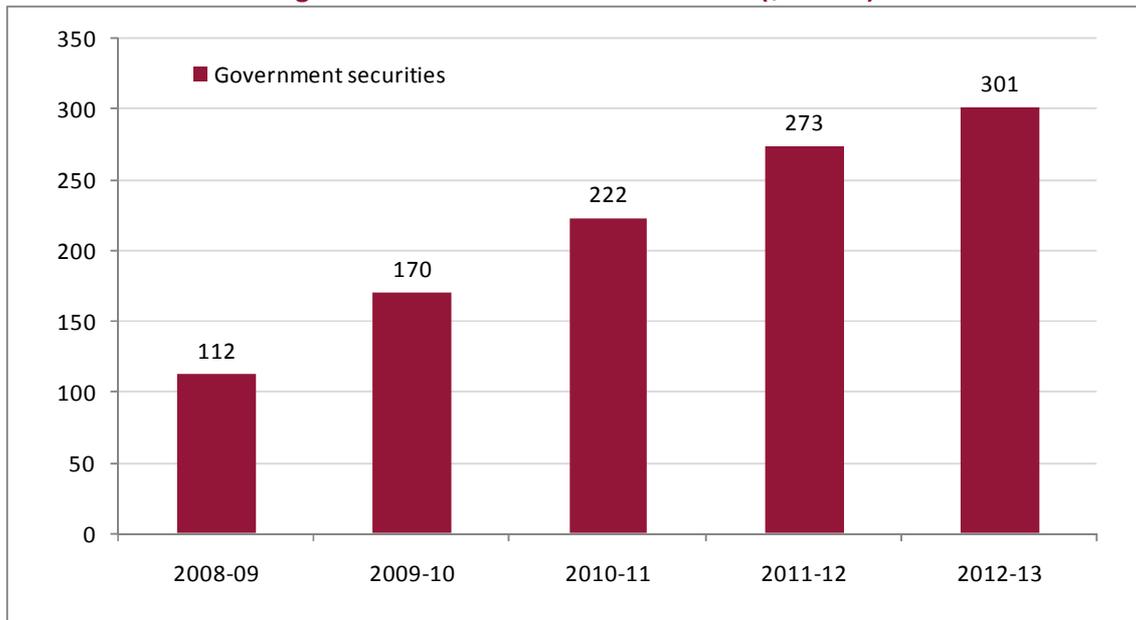
Figure 3.3: Net debt (\$ billion and % of GDP)



Source: Commonwealth 2009-10 Budget Paper 1, Statement 10.

On official forecasts, the total stock of CGS on issue (which is a proxy for gross government debt) is expected to peak at \$301 billion by 2012-13 (over 20% of GDP). It is likely that this elevated level of debt will be with Australia for some years to come.

Figure 3.4: Government bond issuance (\$ billion)



Source: Commonwealth 2009-10 Budget Paper 1, Statement 9.

3.5.2 Broader or contingent liabilities

In addition to the sizeable direct debt the Federal Government has taken on board in the wake of the global financial crisis, there has also been an increase in indirect or contingent liabilities

Contingent liabilities represent possible costs to the government arising from past events or decisions which will be confirmed or otherwise by the outcome of future events that are not within the Government's ability to control. They include loan guarantees, non-loan guarantees, warranties, indemnities, uncalled capital and letters of comfort. These possible costs are in addition to those recognised as liabilities in the consolidated financial statements of the Australian Government general government sector.

The government reports on its significant contingent liabilities in general terms as part of its *Statement of Risks* released with the Budget. Many contingent liabilities are not quantified – for example, the guarantee on State borrowing. Further, items that are quantifiable generally have a relatively remote chance of actually occurring. Nevertheless they should be taken into account when looking at the overall borrowing and debt exposure of the government.

Table 3.4 below provides an overview of the contingent liabilities the Federal Government is exposed to where approximate values could be obtained. The recent economic turmoil associated with the global financial crisis has added markedly to these contingent liabilities mainly as a result of guarantees of bank deposits. **The result is quantified contingent liabilities of around \$930 billion at present. This is around 78% of GDP in 2009-10. When outstanding gross debt is taken into account together with the contingent liabilities, this takes the total government potential exposure to over 90% of GDP in 2009-10.**

Table 3.4: Summary of significant contingent liabilities

| Liability | Approximate amount (\$ billion) |
|--|--|
| Attorney-General's | |
| Indemnities relating to the Air Security Officer program | \$2.0 |
| Defence | |
| Defence and Defence Materiel Organisation - Indemnities | \$3.2 |
| ASC Pty Ltd — Australian Government indemnities provided to Electric Boat Corporation under the services agreement | \$0.0 |
| Litigation cases | \$0.1 |
| Finance and Deregulation | |
| Australian Industry Development Corporation - Guarantee | \$0.1 |
| Litigation | \$4.3 |
| Sale of Sydney Airports Corporation - Indemnity | \$0.5 |
| Foreign Affairs and Trade | |
| Export Finance and Insurance Corporation - guarantee | \$3.0 |
| Health and Ageing | |
| Guarantee Scheme for aged care accommodation bonds | \$7.7 |
| Medical Indemnity Exceptional Claims Scheme | \$0.0 |
| Human Services | |
| Medicare Australia litigation | \$0.1 |
| Immigration and Citizenship | |
| Systems development — liability limit | \$0.2 |
| Infrastructure, Transport, Regional Development and Local Government | |
| Code Management Company — indemnity | \$0.1 |
| Innovation, Industry, Science and Research | |
| Liability for damages caused by Kistler space activities | \$2.2 |
| Liability for damages caused by space activities | \$3.8 |
| Treasury | |
| Guarantees under the Commonwealth Bank Sale Act 1995 | \$5.3 |
| International financial institutions - Net Liability | \$8.7 |
| Reserve Bank of Australia — guarantee | \$77.0 |
| Standby loan facility for the Government of Indonesia | \$1.5 |
| Australian Business Investment Partnership | \$26.0 |
| Car dealer financing — OzCar | \$0.6 |
| Financial Claims Scheme - Deposit guarantee | \$650.0 |
| Guarantee of deposits in authorised deposit-taking institutions | \$19.7 |
| Guarantee of wholesale funding of authorised deposit-taking institutions | \$104.1 |
| Terrorism insurance — commercial cover | \$10.0 |
| Total | \$928.0 |

Source: Commonwealth 2009-10 Budget Paper 1, Statement 8.

4 Conclusions and implications

Given the direct and indirect costs of government borrowing, it is unclear that the public sector has or will continue to have a cost of capital advantage over the private sector:

- Such a conclusion is supported by a number of papers which state that, in the absence of market imperfections, the cost of capital for public projects should be the same as the cost of capital for comparably risky private ventures.⁷
- Such a conclusion is further likely to hold even more over the long run as other fiscal pressures like health and aged care come to pass and increase their call on government borrowing. These pressures will be most pronounced at precisely the time that a greater call on government resources would be needed to militate against longevity risk arising from an ageing population.

The government is in a position to manage default risk to the benefit of specific creditors, but that management comes at a cost.

That applies not only to the direct borrowings of the government, but also to any private borrowings sheltered under a government guarantee.

That raises the possibility of the key beneficiaries of a government guarantee (private borrowers and lenders) paying a fair price (through a levy arrangement) for the insurance provided by the government guarantee.

Note that in the case of a universal guarantee, this would result in no change to the overall cost of capital in the economy – only a shifting of risk away from less credit-worthy pursuits toward those with less inherent credit risk.

⁷ See Grant S and Quiggin J (2001), op cit.

Appendix A: Government Guarantees on Deposits and Wholesale Funding

Source: RBA, Financial System Review, March 2009

On 12 October 2008, the Australian Government announced guarantee arrangements for deposits and wholesale borrowing, following similar announcements in some other countries. Further details of these arrangements – including the announcement of a guarantee fee on large deposits – were released on 24 October following advice from the Council of Financial Regulators. These arrangements were designed to support confidence of depositors in authorised deposit-taking institutions (ADIs) and to help ensure that these institutions continued to have access to capital markets and were not disadvantaged compared to banks in other countries where guarantee arrangements had been announced.

The guarantee on deposits is provided under two schemes, the Financial Claims Scheme and the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding (the Guarantee Scheme).

Under the Financial Claims Scheme, total deposit balances up to and including \$1 million per customer held in eligible ADIs – Australian-owned ADIs and Australian-incorporated ADIs which are subsidiaries of foreign-owned banks – are automatically guaranteed by the Australian Government without charge. The Financial Claims Scheme is estimated to cover the entire deposit balances of over 99 per cent of depositors (by number) with eligible ADIs, as most depositors have relatively small balances.

For customers with total deposit balances over \$1 million at a single eligible ADI, the ADI can access a government guarantee for that portion of the balance over \$1 million through the Guarantee Scheme. To do so, the ADI must apply to the Scheme Administrator (that is, the Reserve Bank of Australia as agent for the Government). The ADI application must include details of the accounts on which the guarantee may be made available, and an undertaking to meet other conditions, including the payment of a risk-based monthly fee by the ADI on the amounts guaranteed. This fee is the same as that applying to wholesale funding (see below). Customers are not obliged to have the guarantee apply to the portion of their total deposit balances over \$1 million, and the fee only applies to the amount of each customer's total deposits above \$1 million that is guaranteed. In most cases, ADIs recover the fee from depositors.

Deposits with foreign bank branches are not guaranteed under the Financial Claims Scheme, given that branches are not locally incorporated entities and independently capitalised in Australia, but are instead part of the foreign bank incorporated overseas. Foreign bank branches are eligible to participate in the Guarantee Scheme, though there is no fee-free threshold and additional conditions apply. For example, approval requires an attestation that the parent bank is meeting prudential requirements in its home jurisdiction, and there are limits on the term and quantity of guaranteed liabilities based on the branch's liabilities outstanding prior to the Guarantee Scheme's introduction. The foreign bank branch must also undertake that the funds will not be used to directly support the parent bank.

The Financial Claims Scheme became effective on 18 October and the Guarantee Scheme became operational on 28 November. A temporary guarantee had applied from 12 October,

while the relevant legislation was being passed for the Financial Claims Scheme and the rules and operational infrastructure of the Guarantee Scheme were being established. Deposit guarantee arrangements will remain in place until 12 October 2011, ahead of which the Government intends to consider subsequent arrangements. The Government noted in its announcement that the Guarantee Scheme would be reviewed on an ongoing basis and revised if necessary.

Eligible ADIs are also able to apply to have their new and/or existing eligible wholesale funding securities guaranteed, for a fee, under the Guarantee Scheme. The guarantee for wholesale funding will operate until market conditions normalise and is subject to the same review procedures as for deposits. As with the guarantee for large deposits, access to the Guarantee Scheme is voluntary and subject to an approval process. A fee is payable on all guaranteed liabilities, with the fee levied monthly. While the same fee applies regardless of the term of the security, fees vary with the credit rating of the ADI.

Only senior unsecured debt instruments of a non-complex nature issued by ADIs are eligible for the guarantee. Eligible ADIs can choose to apply for the Government guarantee for particular securities, or programs, and have other securities unguaranteed. For short-term liabilities, eligible instruments are bank bills, certificates of deposit (including transferable deposits), commercial paper and certain debentures, with maturities up to 15 months. For long-term liabilities with terms to maturity of 15 months up to 60 months, eligible instruments are bonds, notes and certain debentures. Foreign bank branch access to the Guarantee Scheme for wholesale funding involves the same additional conditions and restrictions as outlined for deposits.

Explicit deposit insurance schemes have been common overseas for many years. Faced with the situation of heightened uncertainty and declining confidence in late September/early October 2008, a number of governments around the world responded by increasing the monetary cap on the amount of deposits guaranteed under such schemes. For example, in the United States, the cap on insured deposits with eligible institutions was increased temporarily from US\$100,000 to US\$250,000, while the minimum cap required in European Union (EU) countries was increased from €20,000 to €50,000. Some EU countries including Austria, Denmark, Germany and Ireland went further by providing a guarantee over all deposits, introducing unlimited caps. Most countries that introduced unlimited caps nominated a set period for the arrangements to apply, typically around two years.

Around the same time as they extended deposit protection arrangements, many governments also provided guarantees over wholesale funding, partly in response to the Irish Government's decision to do so. The details of the individual schemes vary considerably across countries, although the EU countries agreed to common principles so the approaches they have adopted are fairly similar. While most governments, both within the EU and outside, that provided support to wholesale funding markets did so by allowing private financial institutions to issue government-guaranteed debt, the approach taken in Austria and France differed in that a separate state-controlled agency was established to raise funding, which is then available to be on-lent to eligible private financial institutions.

The fees charged for the government guarantees on wholesale funding are typically based on the credit rating of the issuer (Australia, Canada and New Zealand), or credit default swap premiums (France, the Netherlands, Spain and the United Kingdom). In contrast, in the United States the fee charged is dependent on the term of the instrument but not the rating of the

issuer. The fee structure adopted in the Netherlands and New Zealand also depends partly on the term of issuance. In a number of countries, including Canada, New Zealand and the United Kingdom, the fee has been revised lower from initial settings, while in the United States it has been revised higher.

Most governments other than Australia's nominated a set deadline for the availability of the guarantee. While the EU guidelines permit schemes that accept applications for up to two years, the EU countries generally set an application deadline of the end of 2009. In Canada, the United Kingdom and United States, considerably shorter periods were set, though in each case the application cut-off date has since been extended, to the end of October 2009 in the United States and to the end of December 2009 in Canada and the United Kingdom. The instruments eligible for the guarantees generally were limited to a maturity of up to three or five years.

As in Australia, governments have typically restricted the offer of a guarantee to senior unsecured debt instruments that are non-complex in nature. They have also restricted the guarantee to debt issued by certain financial institutions. For example, in Ireland, the Netherlands and the United Kingdom, the guarantee is only available to those institutions that have a significant presence in those countries' financial systems. In the United Kingdom, eligibility is also dependent on an institution having raised, or planning to raise, Tier 1 capital by a certain amount, either by government subscription or from other sources.

Appendix B: Challenges For Economic Policy

Glenn Stevens' address to the Anika Foundation Luncheon, Sydney – 28 July 2009 (extract)

Part of the way ahead will, at some point, involve winding back the extensive government guarantees (and in some cases extensive public ownership) of financial institutions around the world. These measures were necessary last October in the extreme uncertainty of the time, and played a critical role in stabilising confidence in the core of the financial system, and re-opening key capital markets. But they are undesirable as a permanent feature of the landscape. Countries that issued very generous or even unlimited guarantees of deposits will want to make sure such steps truly were emergency measures, by scaling them back to a more sustainable set of deposit insurance arrangements. Likewise, it would be desirable that guarantees for wholesale raisings in capital markets lapse into disuse as conditions improve.

To date, in excess of US\$800 billion of government-guaranteed debt has been issued in public markets by banks around the world. An unknown additional sum has been placed into private hands directly. Taking account of the additional debt governments are issuing for regular fiscal purposes, plus the funding for bank rescue packages, the shape of global capital markets is changing significantly. Government and government-guaranteed debt of one form or another is rapidly increasing globally. This has been accommodated so far because it has, by and large, matched investors' shifting risk preferences. Certainly people will worry, longer term, about increases in long-term interest rates potentially 'crowding out' private borrowers. To date, though, long-term rates remain historically pretty low for public borrowers, despite the prospect of very large debt issuance. They have increased somewhat, but this is best understood as an unwinding of the extreme risk aversion of 2008 and early 2009.

But the longer-term question is whether, even without adverse effects on borrowing costs, we would really want to keep moving in the direction of a world where the bulk of debt is government-issued or government-guaranteed. It seems to me that that could easily be a world in which investors end up being no more discerning about risk and return than the buyers of CDOs a few years ago, and in which banks themselves ultimately rely on the guarantees to an inappropriate or even dangerous extent. More generally, while some countries do need significant regulatory reforms in the financial sector, do we want to throw away the genuine advances of risk management and globalisation of the past generation?

Surely the better world for the decades ahead is one where a global financial system, having been stabilised at a time of crisis by public intervention (at major cost to shareholders and incumbent managers as well as taxpayers), plays its proper role of capital allocation and risk management. To be sure, it failed to perform as promised in the recent past. But it would be preferable, in my judgement, to work at making the system more effective in doing that job, than to retreat into the financial repression of an earlier state of the world. The banks of the United States and Europe are starting down this path on their wholesale issuance, having recognised that it is in their own interests to do so. It would make sense for Australian banks, which have accounted for 10 per cent of global issuance of government-guaranteed bank debt over the past nine months, to step up their efforts to do likewise.