FUTURE FUND OR F

only way the government can make-up this projected shortfall is through increasing revenue, reducing spending, or some combination of the two.

The government argues that 'future governments should not have to cut services or raise taxes in order to meet growing demographic pressures in areas like

> What the government does not say is that putting money in the Future Fund is the equivalent of cutting services or raising taxes today.

health and aged care.'[4] What the government does not say is that putting money in the Future Fund is the equivalent of cutting services or raising taxes today. The Future Fund does not change the future value of the liabilities associated with public sector superannuation, or an ageing population more generally. While the return on Future Fund assets will increase the Commonwealth's capacity to meet these obligations in future, this return is simply compensation for the opportunity cost of not using these funds today. There is no essential difference between meeting these liabilities out of current or future taxes.

The only way the government can close the projected fiscal deficit identified in the Intergenerational Report is to change existing tax and spending policies to put the budget on a more sustainable long-term footing. Yet the government has consistently expanded entitlement and other spending programs that are likely to make this projected fiscal shortfall even larger. Commonwealth fiscal policy is thus working at cross purposes: providing for some of its future liabilities via the Future Fund on the one hand, while expanding the future scope of these liabilities through expanded government spending programs on the other.

Treasury Secretary Ken Henry has noted that 'pro-growth policies, focused on participation and productivity, offer the best prospects of meeting the looming fiscal challenge without compromising the living standards of future generations.'[5] Research by the Centre for Independent Studies has highlighted the fact that the federal government's current tax and spending regime inhibits workforce participation and productivity.[6] Rather than hoarding revenue it doesn't need to meet current expenditures in the Future Fund, the government should instead focus on overhauling federal tax and spending programs in a pro-growth fashion. By growing the economy today, we are better placed to meet future government spending obligations out of future rather than current revenue.

Budget surpluses and Commonwealth net debt

The Future Fund has also been designed to solve a more immediate problem. The run of federal budget surpluses since 1997–98 (excluding a deficit in 2001–02) has seen the federal government retire debt to the point that, in 2005–06, the government started accumulating a negative net debt position. On current projections, the government's net debt position is expected to be -4.3% of GDP by 2009–10.[7] This presents the government with the problem of what to do with revenue the government doesn't need to fund current expenditures, if it is not to return these funds to taxpayers through additional tax cuts. To date, this has not been an issue, because the federal government has used budget surpluses to retire debt. However, the amount of federal government bonds outstanding is now close to the minimum required to sustain the liquidity and smooth functioning of the market for these securities. Budget surpluses also drain private sector liquidity unless the proceeds are recycled via purchases of government debt.

The Future Fund addresses this problem by having the federal government purchase other financial assets instead. However, these purchases still incur the same opportunity cost highlighted previously. In acquiring financial assets, the government is forgoing opportunities to use these funds today to put in place a better tax and spending regime and the associated benefits for the Australian economy. The economy-wide returns on an improved federal tax and spending regime could be expected to exceed those accruing to a portfolio of financial assets held by the government in the Future Fund.

Future Fund Chairman David Murray has claimed that increased saving via the Future Fund will lower macroeconomic volatility and Australia's cost of capital, improving productivity and investment.[8] This assumes that increased government saving via the Future Fund does not come at the expense of private sector saving, leaving national saving unchanged. Indeed, a large part of the federal budget surplus can be accounted for by way of taxes on private superannuation. However, even if it were true that the Future Fund could increase national saving to the point of lowering the cost of capital, this would amount to a serious distortion to capital markets and could even conceivably result in an overcapitalisation of the economy and a long-term reduction in overall productivity. The Japanese government's efforts to promote increased saving had exactly this effect on the Japanese economy.[9] Markets, and not government, are better placed to determine the appropriate level of national saving and investment.

Murray's comments are consistent with the government's argument that budget surpluses put downward pressure on interest rates. As Alan Reynolds notes, 'sustained changes in real interest rates are driven by the real return on invested capital, which makes promises to boost growth with lower real interest rates illogical.'[10] To argue that budget surpluses and Future Fund assets will lower interest rates is thus equivalent to claiming that the return on invested capital will fall. Even in terms of purely cyclical influences on interest rates, the government's budget position is a relatively minor influence. The high nominal interest rates of the late 1980s were in fact associated with some of the largest budget surpluses as a share of GDP in recent decades. This should not be surprising. Interest rates rise when the economy is strong, which also improves the government's budget position. Interest rates and the government's budget balance are positively, not negatively correlated, because of their shared relationship with the economic cycle.

The Future Fund might also contribute to increased macroeconomic volatility, by reducing the scope of future governments to run a counter-cyclical fiscal policy, given that the current legislation limits the purposes for which the Future Fund can be used. While the government retains discretion over the amount it puts into the Fund, the government's target for Future Fund assets at the same time implies a commitment to maintain contributions at a level that will meet this objective.

Future Fund governance and financial markets

The Future Fund legislation outlines in general terms how the Fund's assets will be managed. The Future Fund is limited to investing in financial assets. It cannot make direct investments in infrastructure or property, or assume control of listed or unlisted companies. These proscriptions prevent the Future Fund from effectively nationalising the equity capital of private firms or other assets.

The Fund's financial assets will be managed by private investment managers chosen by the Future Fund Management Board. This still involves the Fund in making important investment decisions, since the Fund must choose among the investment strategies on offer from the various private sector fund managers. While it is unlikely that the Future Fund will in itself influence long-run rates of return on invested capital, it may still have the capacity to distort financial market prices at the margin. The government has indicated that it expects most of the Fund's assets to be invested domestically. The Future Fund will potentially be a significant player in domestic capital markets to the extent that it adopts an active rather than passive approach to investing. The Fund has already acknowledged its capacity to distort financial markets by undertaking not to adversely affect liquidity in the market for Commonwealth government bonds.[11] Fund Chairman David Murray was quoted in *The Australian*, in relation to the timing of the Future Fund's investment, as saying that 'I won't signal that because that would be giving signals to the market.'[12] This is implicit recognition of the capacity of the Fund to distort financial market prices.

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Many of these issues were anticipated in the US context by Alan Greenspan in a speech in 2001, in which he warned of the implications of the government running a negative net debt position and the consequences for financial markets:

> Once Treasury debt reaches its irreducible minimum, additional surpluses will, of necessity, lead to the accumulation of substantial private—that is to say, non-federal—assets either in the Treasury's general fund or in government trust funds. The decisions on how such funds should be invested by the government would necessarily be political ones, and would lead to efforts by some groups to obtain via the political process funding that

> they could not obtain, at least at the same price, in private markets.
>
> These efforts would likely result in distortions in the allocation of capital that must be balanced against the benefit to the nation of the increase in saving. In fact, it is the market-driven allocation of capital and labor to their most productive uses that has fostered our recent impressive gains in productivity and encouraged inflows of capital that have enabled us to build an extraordinarily efficient capital stock despite quite modest levels of domestic savings. The effectiveness of our markets in allocating capital is one of our nation's most valuable assets. We need to be careful not to impair their functioning.[13]

Greenspan's concerns about the potential for the politicisation of a government-managed asset portfolio are well illustrated by the recent outcry over NSW Treasury Corporation's investment on behalf of public sector employees in Altria Group, owner of cigarette manufacturer Philip Morris.[14] The 2002 controversy over unrealised foreign exchange losses on cross-currency swaps in the federal government's debt portfolio also illustrates how easy it is to politicise what should otherwise be uncontroversial investment decisions.[15] The Future Fund's investments will inevitably receive similar scrutiny. Regardless of whether the design of the Future Fund adequately addresses these issues, it remains subject to a problem of time inconsistency. No matter how much the government promises to manage the Fund in a particular fashion today, future governments might make very different decisions about the Fund's assets. Indeed, the most obvious future temptation would be to use the Fund to avoid having to make politically difficult decisions about the fiscal implications of an ageing population as pressures on the budget grow.

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Opposition Leader Kim Beazley has already indicated that 'instead of the government's Future Fund, Labor would establish its Building Australia Fund, and allow the income streams from that fund to be applied to infrastructure purposes.'[16]

Alternative policy options

It has already been argued that large federal budget surpluses provide an opportunity to restructure federal tax and spending programs to provide for the long-term future growth of the Australian economy. This is the most effective way to provide for the future demands of an ageing population. Peter Saunders of the Centre for Independent Studies has proposed that the Commonwealth's budget surpluses be used to endow individual private saving accounts that would empower individuals to meet their own needs and reduce their future dependence on government.[17] This approach avoids the serious governance and time-inconsistency problems that plague the government's effort to establish itself as an inter-generational financial intermediary, substituting public for private saving and investment via the Future Fund.