Approaching budget deficits, debts and money in a socially responsible manner

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Outline

- Relationships between the creation of central bank money and budget deficits.
- People’s quantitative easing (and similar) do not add anything to that which can be secured through conventional fiscal policy and risks placing expenditure decisions in the hands of the central bank.
- ‘Golden rule of public finance’ should be regarded as tarnished and that it has little to recommend its adoption other than its political rhetorical appeal.
Outline

- ‘Functional finance’ approach that the budget position should be set seeking to secure high levels of employment.
- Political and social obstacles to full employment budget deficit.
- Range of estimates of the multiplier indicate practical difficulties in the operation of fiscal policy designed to achieve high levels of employment.
Outline

- A balanced structural budget are critically examined with emphasis on the problematic nature of ‘potential output’, and the argument that the achievement of a balanced structural budget may not be feasible.
- The use of interest rates to achieve a high level of demand.
- Sustainability of debt
- Notion of ‘fiscal space’
Remarks on employment objective

- Objective is expressed in terms of high rate of employment.
- Recognize the difficulties of defining full employment in an economy with workers on zero hours contracts, part-time workers often working less hours than they wish and discouraged worker effects.
- What is regarded as high employment is socially determined.
- Appropriate fiscal policy and demand management policies necessary but not sufficient condition for high employment, and sufficient productive capacity in relevant locations required.
Central bank money and budget deficits

- Central government generally deals in central bank money: though this is not a logical necessity and other tiers of government often use commercial banking system.
- The ‘initial finance’/ ‘final finance’ (funding) distinction from the circuitist literature needs to be applied to government and central bank.
- Government can only spend if initial finance available: potentially depends on decisions of central bank.
- Money created alongside spending, destroyed through tax payments and bond sales.
Central bank money and budget deficits

- Key question is **not** whether central bank money can be created at zero cost and is available to government to finance expenditure (which it generally is).

- Key questions are:
  - The implications of the budget deficit = net private savings relationship for the holding of additions to money and to bonds.
Central bank money and budget deficits

- The effects on the asset and liability portfolios of banks and public.
- Not to mention the social desirability of proposed expenditure!
- Other considerations: the degree to which government expenditure involves imports (and acceptability by foreigners of its currency); and the current account effects of increased expenditure by government and induced private expenditure.
People’s Quantitative Easing

- Proposals to utilise quantitative easing for ‘good causes’ (has there been any proposals for a defence QE?)
- Argument is made that such proposals put decisions on which expenditure is to be promoted in the hands of undemocratic central bankers.
- There are no benefits arising from people’s QE which cannot be realised through fiscal policy which will be financed by central bank money.
The tarnished ‘golden rule’

- Golden rule: borrowing to cover public investment
- Commits ‘government as household fallacy’, and most public investment does not yield direct monetary return to government.
- Public investment should be judged on social benefits/social costs and not on basis of government revenues and costs
The tarnished ‘golden rule’

- ‘Golden rule’ does not specify the appropriate level of public investment, and in general would involve budget deficit which is not socially desirable (as indicated below)

- From aggregate demand perspective, capital expenditure is not essentially different from current expenditure
Fiscal policy for high employment

- The objective of fiscal policy should be securing high employment (noting the difficulties of defining full employment)

\[ G - T(Y^*) = S(Y^*) - I(Y^*) - CA (Y^*) \]

- where \( Y^* \) is the level of output/income consistent with a high level of employment and CA is current account position.

\[ BD \leq S^* - I^* + FA^* \]

- where * after variable signifies its level if high level of employment were achieved.
Political and social obstacles

- The well-known deficit and debt scares: yet governments typically run deficits: how else would debt ratios run of the order 50 to 100 per cent.
- Kalecki’s arguments on the political obstacles to the use of fiscal policy to achieve full employment
On multipliers and fiscal consolidation

- The multiplier (in terms of difference in income $Y$ divided by difference in government expenditure $G$) will depend on position in business cycle, changes in other components of investment whether induced by $G$ or accompanying $G$ in the cycle.
- The ‘expansionary fiscal consolidation’ thesis: reflection of the cyclical nature of capitalist economy.
- The range of multiplier estimates illustrate the difficulties of operating a fiscal policy to achieve high level of employment.
Structural budgets

- Structural budget is position which would arise when economy is operating at ‘potential output’ with present expenditure and tax plans.
- Formulating fiscal policy in terms of structural budget faces range of issues: note two here.
- ‘Potential output’ is a theoretical construct which (probably) does not exist in the real world. Estimates of ‘potential output’ appear to be path dependent, Estimates of structural budget crucially dependent on ‘potential output’.
Structural budgets

- Little reason to believe that a balanced structural budget is feasible.

- Consider whether the relationship
  \[ S^p - I^p + FA^p = 0 \]
  Would hold where superscript \( p \) indicates that, the variable concerned refers to the desired (by economic agents) conditional on the level of economic activity being at potential output.

- It would need to hold to enable the structural budget deficit to be zero
Interest rates

- Treat interest rates as potentially having some but limited impact on aggregate demand.
- Central bank interest rate policy has to be geared towards other objectives such as exchange rate and financial stability.
Sustainability of debt

- Budget deficit (relative to GDP) of $c^*$ would lead to government debt (relative to GDP) of $c^*/g$
- Treating $c^*$ as the average over the cycle budget deficit which secures high levels of employment, and as argued above can be funded: and hence in general debt is correspondingly accepted.
Sustainability of debt

- For aggregate demand purposes it is total deficit which is relevant, though it can increasingly become interest payments.
- Debt convergence resulting from primary budget deficit provided $r < g$: for which number of authors including IMF suggests often reflects actual conditions.
Sustainability of debt

- Debt to GDP ratio can potentially be too high – e.g. if it persistently exceeds the c*/g indicated above. The desirable debt to GDP ratio should be judged on those terms.

- Cast doubts, empirically and theoretical, on notions of a ‘tipping point’ debt to GDP ratio beyond which economic growth etc deteriorates.
Sustainability of debt

- Household borrowing and debts raise more substantial issues of sustainability.
- Similarly, foreign borrowing and debts denominated in foreign currency raise substantial issues of sustainability.
‘Fiscal space’

- Fiscal space is “the room for undertaking discretionary fiscal policy relative to existing plans without endangering market access and debt sustainability” (IMF (2018 ,p. 1).

- The approach above of using budget deficit to achieve high level of employment could be interpreted as operating with zero fiscal space.

- However, the crucial difference appears to be the emphasis which ‘fiscal space’ places on debt ratios applied across most countries without regard to their individual circumstance.