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Why worry about fiscal deficits?

With the counter-revolution against Keynesian and development economics in the early 1980s, budget deficits have become taboo although fiscal deficits have played a leading role since the Great Depression of the 1930s in maintaining full-employment in developed countries.

Deficits and surpluses were adjusted counter-cyclically through business cycles.[1] In his 1936 budget speech, President Roosevelt noted, "the deficit of today … is making possible the surplus of tomorrow." Therefore, governments should not feel that "there is anything especially good or bad about [budget surpluses or deficits]; [they] should merely concentrate on keeping the total rate of spending neither too small nor too great, in this way preventing both unemployment and inflation."[2]

Governments have played a major role in developing countries, in building infrastructure and providing basic public services such as health-care and education. They often did not have the resources or recourse to large scale foreign aid, as war-torn Europe had, with the Marshall Plan, to rebuild their economies. Thus, the only way they could develop their newly decolonized countries was by running deficits, financed essentially by printing money.[3]

This was also the case when the US emerged as a newly independent nation. Alexander Hamilton, the first US Treasury Secretary under President Washington, incurred debt as a way of establishing "sound credit".[4]

The fall of fiscal policy from grace followed the ascendancy of market-fundamentalist conservative politics after the election of Margaret Thatcher in the UK and Ronald Reagan in the US. Their distrust of governments has favored rule-based policies that have constrained discretionary government spending, including the Gramm-Rudman-Hollings deficit control legislation in the US and the EU's Stability and Growth Pact.

The current crisis, like the Great Depression, has shown the fallacy of adhering to such strict rules. Governments and central banks (e.g. in the US) have shrugged off these fetters. And instead of insisting on "sound" fiscal policy, many developing countries have also introduced fiscal stimuli. However, with the "green shoots" of recovery since mid-2009, there have been dire warnings about ballooning deficits, especially by financial lobbies, and renewed calls to cut reflationary spending to avoid inflation. Meanwhile, the IMF insists on deficit reduction in developing countries. Hence, its fiscal policy advice remains basically contractionary in the medium term.[5]

Such debates about fiscal policy are not new. For example, for re-election in 1937, President Roosevelt

[1] R. C. O. Matthews (1968). 'Why Has Britain Had Full Employment Since the War?' *Economic Journal.*

[2] Abba Lerner (1943). "Functional finance and the federal debt" *Social Research*, 10(1): 38-57

[3] Michael Kalecki (1976), *Essays on Development Economics*, Brighton: Harvester Press. However, some early development economists, e.g. V.K.R.V. Rao and A.K. Dasgupta, were sceptical about the effectiveness of fiscal policy in creating job. They believed Keynesian fiscal activism would create inflation, but they offered different reasons for such an outcome. See V.K.R.V. Rao (1952). "Investment, Income and the Multiplier in an Underdeveloped Economy" *Indian Economic Review*, 1(1): 55-67. Amiya K. Dasgupta (1954). "Keynesian Economics and Under-Developed Countries". *Economic and Political Weekly*, January 26.

[4] This was mainly financed by printing money. Hamilton established a national mint, and introduced tariffs for temporarily protecting new firms to foster the development of competitive national industries. These measures placed the credit of the federal government on a firm foundation, giving it all the revenues it needed.

[5] See Mark Weisbrot, Rebecca Ray, Jake Johnston, Jose Antonio Cordero and Juan Antonio Montecino (2009). "IMF-Supported Macroeconomic Policies and the World Recession: A Look at Forty-one Borrowing Countries". CEPR, October, Washington, DC. Although the IMF has challenged the CEPR findings, the IMF's own definition of "pro-cyclicality" and methodology for determining program effects are too narrow. In an economic slowdown, fiscal deficits normally grow as revenues decline and social spending increases; some of these may be institutionalized as automatic stabilizers. Note that discretionary changes in spending or tax measures may be pro- or counter-cyclical.

backed away from his New Deal and promised that "a balanced budget [was] on the way". In 1938, he slashed government spending, citing inflationary fears, causing unemployment to shoot up to 19%.

Evsey Domar (1944) noted "Opponents of deficit financing often disregard ... completely, or imply, without any proof, that income will not rise as fast as the debt… There is something inherently odd about any economy with a continuous stream of investment expenditures and a stationary national income."[6]

Understanding this means abandoning the narrow concept of "sound" finance in favour of "functional" finance, which evaluates government finance based on its impact. According to Lerner (1943: 39), "The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound or unsound."

Therefore, debt is sustainable if government expenditure is both growth- and productivity- enhancing. The notion that government deficits will need to be 'financed' through higher taxes in the future is spurious as revenues will rise in an expanding economy.

A lingering concern is the financing of the deficit. The first recourse for governments is to borrow domestically, raising the spectre of "crowding-out", i.e. government borrowings driving up interest rates and adversely affecting private investment. This ignores the consequences (e.g. low profitability, bankruptcies, etc.) of a depressed economy. Government action is necessitated, in the first place, by inadequate private spending causing the collapse of the private sector.[7]

Moreover, the immediate financial implication of expansionary fiscal policy action when the central bank uses interest rates – in a world of 'endogenous money' – is to add to the cash reserves of private sector banks in which government checks are deposited. This, in turn, increases (net) liquidity if the central bank does not implement offsetting money market operations. Hence, the actual central bank discount rate should decrease, exerting downward pressures on retail interest rates. This should, therefore, encourage – rather than crowd-out – private investment.

In the absence of a well-developed capital market, the option for most developing countries is borrowing from the central bank, commonly referred to as printing money. The opposition to this option stems from the presumed link between printing money and inflation. This fear arises from lack of appreciation of the root cause of the problem, i.e. insufficient spending or inadequate demand.

Printing money in a depressed economy should not cause inflation. The objective is to keep total spending "neither greater nor less than that rate which at the current prices would buy all the goods that is possible to produce."[8] If expansionary fiscal policy achieves its intended purpose of boosting output and employment, increased money supply will match the increased demand for money needed for a higher level of transactions.

Some inflationary pressure due to expansionary fiscal policy is inevitable, but that does not depend on the mode of financing the deficit. Instead, price rises are inevitable in an expanding economy undergoing structural change. There is no evidence of runaway inflation just because some prices rise. Policy makers should ensure the expansion of sectors desirable for long-term development.

In sum, fiscal policy should help maintain full employment and achieve structural change. Fiscal deficits do not lead to hyper-inflation if deficits serve to enhance productive capacity.

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[6] Evsey Domar (1944). "The Burden of the Debt and the National Income". *American Economic Review*, 34(4): 798-827.

[7] For a review of the theoretical debate, see Philip Arestis and Malcolm Sawyer (2004). "Fiscal Policy: A Potent Instrument". *New School Economic Review*, 1(1):15-21. Reviewing the empirical literature on both developed and developing countries, one IMF study concluded that fiscal multipliers have been overwhelmingly positive. See Richard Hemming, Michael Kell and Selma Mahfouz (2002). "The Effectiveness of Fiscal Policy in Stimulating Economic Activity – A Review of the Literature". IMF Working Paper WP/02/208.

[8] Abba Lerner, *op cit.* p. 39.