

## **Public Sector Deficits are the Solution, not the Problem**

### **Ideology of Balancing Budgets**

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With the presidential election in the rearview mirror, a so-called fiscal cliff alleged threatens disaster for the US economy. The time has come to drive a stake through the ideology of the budget cuts, not only in the United States but also Europe. This ideology draws great support from the creeping *coup* that replaced economics with nonsense as the guide to public policy.

In the ideologically reactionary period that we find ourselves, all but a few politicians and almost all the media in North America and Europe present as self-evident and needing no defense the proposition that governments should continuously balance their budgets and not accumulate debt. Lack of an economic or even accounting justification for balancing the budget has not stopped this fiscal foolishness from justifying appallingly anti-social policies under the umbrella of "austerity", policies provoking suicides in Spain.

The "Austerity Doctrine" maintains that current public revenues should cover government expenditures, and if not, tax increases and/or spending reductions must quickly correct the deficit. Part of this ideology is the fantasy that "fiscal correction" will have little or no impact on total output or growth because expansion of the private sector automatically compensates for the contraction of the public sector.

As shamelessly simplistic as it is, the balancing budgets doctrine captures hearts and minds of much of the public. When not presented in full form like a rabbit from a magician's hat, the anti-deficit argument would seem to find *faux* respectability in two separate but complementary arguments. I take first the "impersonal forces of markets" argument, which posits that financial "investors" continuously evaluate the ability of governments to meet their debt obligations. The growth of debt allegedly reduces the faith that "markets" have in the ability of governments to meet those obligations.

Public debt grows because of government fiscal deficits, so it follows that deficits increase "market fears" of non-payment. These fears induce "investors" to demand

higher interest rates to lend to governments, which further increase the perception of future debt default. To prevent this unhappy ("vicious") cycle governments should not run fiscal deficits. If a deficit exists, the government must eliminate it either through increased taxes or reduced expenditures. Because "everyone knows" that the public would not accept tax increases, there-is-no-alternative (TINA) to budget cuts. Objective forces that no one can change make eliminating deficits unavoidable.

We find running parallel to the market forces argument the "crowding out" critique of deficits. Governments finance deficits by borrowing, selling bonds in financial markets. At any moment intelligent and rational "investors" are happy with the amount of government bonds they hold. In order to sell more bonds, the government must increase their return, which means raising the interest rate on the bonds. Private companies borrow in the same financial markets as the government.

When the interest rate on public bonds rises, the private sector must also pay more to borrow. At higher borrowing rates, the private sector, quite naturally, will borrow less, meaning less investment. Through its own borrowing, the government "crowds" out private investment. The process is rather like a person forcing her/himself into a crowded elevator, thus expelling someone else, because there is just so much room.

Put the two arguments together and they seem to make a tidy little package against all deficit finance, and it has a very pleasing corollary for those opposed to public spending. Public borrowing that crowds out private borrowing is just a special case of a more general phenomenon. What if the government has a surplus and spends more? No borrowing is required, but the private sector will still suffer from government "crowding", because credit is not the only resource required by both government and business. Both hire people, use inputs such as electricity, perhaps even compete over land. Therefore, any public expenditure reduces private spending, by both businesses and households, by pushing up input costs, including wages.

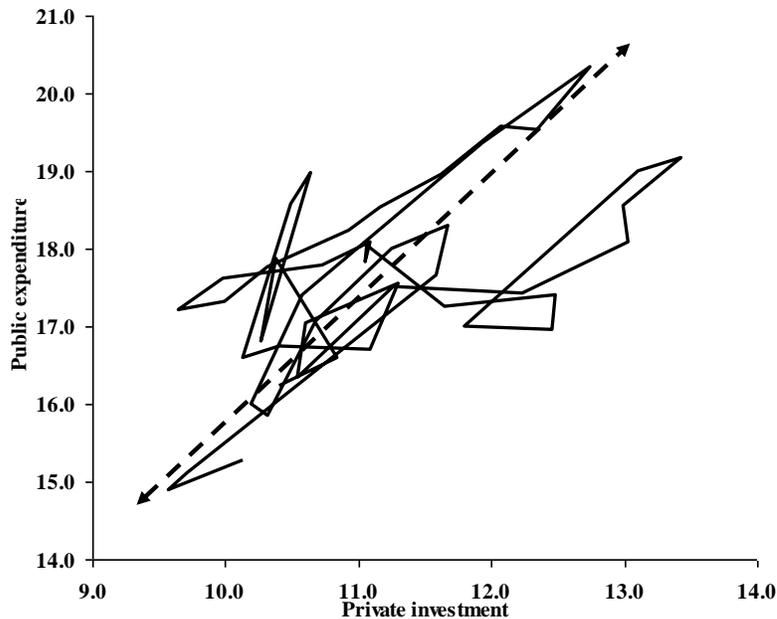
It just gets worse when you believe this nonsense, because the government can create money and the private sector cannot. In other words, the private sector has no defense against the pernicious ability of government to grab scarce resources. The person didn't know the half of it who said, "the best government is that which governs least" (John Louis O'Sullivan, 1837, in the *United States Magazine and Democratic Review*,

and certainly not Thomas Jefferson to whom it is always attributed). The full right wing version is, "the best government is that which spends least".

This tidy, all-purpose critique of public expenditure suffers from a fundamental flaw. It is nonsense. The entire logic, if one can call it that, rests on the presumption that the economy continuously operates at its full potential. If the doors open to a half empty elevator, no one need exit to let a new person in. The analogy is appropriate for public and private spending, and most emphatically appropriate when deficits increase.

When resources are fully employed, governments, business, or households can each spend more only if one or two of the others were to spend less. When resources are idle, governments, business, and households can all spend more. In the experience of the advanced countries over the last several decades resources have been idle much more often that they have been fully employed. In the chart below clearly shows the positive, re-enforcing effect of public expenditure on private investment.

US public expenditure and private investment, 1965-2011  
(shares in GDP)



Source: *Economic Report of the President 2012*.

After 2007 idle resources in almost every advanced country reached scandalous levels. The suggestion that public expenditure might crowd out private investment and

consumption has little foundation most of the time, and none since the global financial collapse of 2008. As for public borrowing driving up interest rates, this depends entirely on the specific circumstances of each country.

## Budget Madness

From the end of the Second World War until the election of Ronald Reagan as president of the United States the politics of public spending at the federal level followed a consistent pattern. The most of the Democratic national politicians supported a broadening of social support programs to cover more people and services, while most Republican politicians opposed this broadening while not seeking to drastically alter the programs. Though an over-simplification, I characterize US domestic politics during the thirty-five years, 1945-1980, as incorporating a consensus that the public and private sectors complement each other, each having its legitimate role.

The election of 1964 provides clear evidence of this truly centrist coalition. The Republican Party convention rejected several moderate candidates, most notably Nelson Rockefeller (ultra-millionaire and governor of New York), in favor of a right wing senator from Arizona, Barry Goldwater. In a 1960 ghostwritten statement of his convictions, Goldwater's ghost told the faithful,

I have little interest in streamlining government or in making it more efficient, for I mean to reduce its size. I do not undertake to promote welfare, for I propose to extend freedom. My aim is not to pass laws, but to repeal them.  
(*Conscience of a Conservative*, page 15)

Offered a straight-up choice between this promise to dismantle the public sector and the last New Deal Democratic president, Lyndon Johnson, the latter won the largest popular majority in the history of US presidential elections, 61 percent (Franklin Roosevelt took 60.8 percent in 1936, and Richard Nixon would win 60.7 in 1972). Other than his own state of Arizona, Goldwater won five in the deep South, a direct result of Johnson's championing of the Civil Rights Act passed a few months before the election.

The defeat of the incipiently neo-liberal Jimmy Carter in 1980 by the right wing Ronald Reagan formally and definitively ended the post war political consensus. Very much in the Goldwater tradition, Reagan would say in his January 1981 inaugural

address, "In this crisis, government is not the solution to our problems; government is the problem". This anti-social doctrine would manifest itself a decade later by the first of an unbroken series of bitter conflicts over not merely the level but the legitimacy of public spending, and the public sector itself. Certainly in Britain and to a lesser extent in the euro zone countries mainstream politicians of the right might secretly harbor the same reactionary dream of a direct assault on the public sector. However, political circumstances in Europe dictate that politicians show a façade of regret for the putative necessity of the austerity that destroys the public sector.

Not so in the United States, where debate over the legitimacy of "government" makes fiscal austerity a derivative issue. The approach of the far right extremists of the Republican Party in the twenty-first century to the public sector renders logic unnecessary and irrelevant. These extremists require no justification for their loathing of the public sector at all levels, just as a Christian fanatic requires a no justification for adherence to the Bible. None the less, the right wing of the economics profession (i.e., almost all of it) aided and abated this anti-societal ultra individualism, and eagerly supported its wild allegations.

As part of what he called the "Dark Ages" of economics, Paul Krugman observed that "one of the many unpleasant things we've learned in this crisis is that there was plenty of intellectual corruption in the economics profession from the get-go" (<http://krugman.blogs.nytimes.com/2012/07/14/is-our-economists-learning/>). An economic manifesto for losing presidential candidate Mitt Romney provided an excellent and appalling example of "intellectual corruption". In "The Romney Program for Economic Recovery, Growth and Jobs", four putatively respectable economists, three of whom could claim widely used undergraduate textbooks, urged Americans to vote for the multi-zillionaire in order to "stop runaway federal spending and debt", reduce tax rates for the wealthy, reduce growth of public sector retirement and medical benefits, and "remove regulatory impediments to energy production and innovation". The reactionary nonsense found in this document, "a concerned effort by three economists...to destroy their own reputations", wrote Krugman, pales alongside the thought that at least a generation of university students used and use their introductory textbooks.

The fact is, if the entertainment of facts were allowed in the US budget debates, that public spending and taxes in the United States fall well below almost any high-income country, and below most middle income countries.

Public Expenditure and Revenue in 6 High Income Countries, 2007 and 2011  
(percentage of GDP, all levels of government)

	Tot Expenditure		Tot Revenue		Fiscal balance	
	2007	2011	2007	2011	2007	2011
United States	37	42	34	32	-3	-10
Japan	36	43	34	33	-2	-10
Germany	43	46	44	45	0	-1
United Kingdom	44	49	41	41	-3	-8
Italy	48	50	46	46	-2	-4
France	53	56	50	51	-3	-5

The media and the right wing economists consistently misrepresent statistics on public finances. Both are typically motivated by the intention to present public deficits and debt as irresponsible and dangerous. The truth is quite the contrary. Except in rare circumstances, deficits and debt are responsible and safe. Deficits and debt are typically *good things*, contributing to social welfare, and public sector surpluses and the absence of debt are typically dysfunction, *bad things* for the well-being of households and businesses.

To many if not most this characterization of deficits and debt is absurd. With this skepticism in mind, I begin with analysis of the US deficit. The first and fundamental step in understanding public sector deficits is that in most cases they do not result from excessive spending. They result from recessions. The way this happens is simply explained. In all but the most underdeveloped countries, public revenue increases as the economy grows.

As countries develop, taxes on expenditures and incomes, of both households and businesses, increase to the point of overwhelming all other sources of revenue, such as tariffs and fees charged by governments. Income and sales taxes have two very useful characteristics, governments find them easy to collect and they increase as the economy grows. Their ease of collection results from their concentration in businesses, either as sales revenue or as payments to employees and suppliers. In practice, businesses collect

both types of taxes, paying governments sales taxes and "withholding" taxes of employees (they "self collect"), and governments monitor their adherence to the tax laws.

When the economy grows, that growth consists of business revenue, "output". Public revenue from taxes on business revenue also increases as the economy grows. This may seem so obvious that it need not be explained, much less explained in tedious detail. The explanation is necessary because it has major implications for our assessments of public sector deficits.

No important category of public expenditure increases automatically as the economy grows; quite the contrary. Expenditures fall into two general categories, those determined by specific legislation and those linked to unemployment and poverty. The first category is by far the larger, including expenditures on health, education, the military, and public sector pensions. Legislatures allocate the funds for each of these to a great extent independently of the state of the economy.

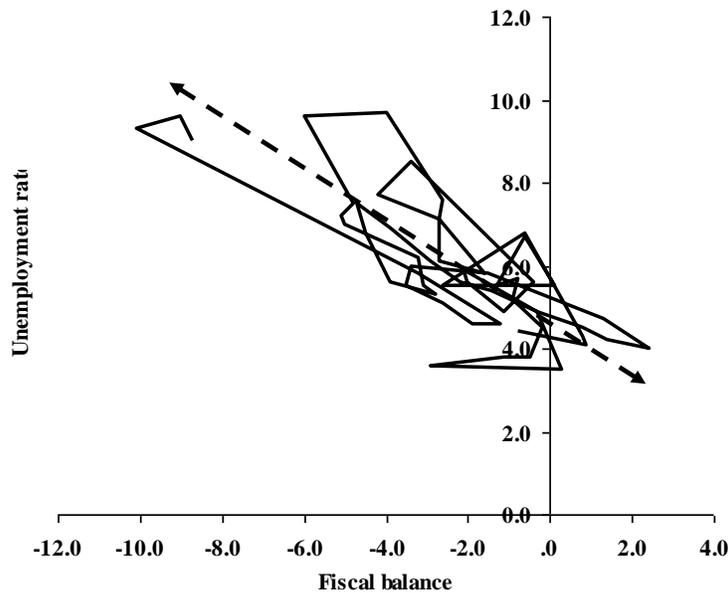
The expenditures linked to unemployment and poverty change opposite to the changes in the health of the economy. Unemployment declines as the economy grows, which reduce compensation payments. In some countries, and the United States is an example, an ear-marked tax funds payments to the unemployed. Therefore, when the economy grows, the unemployment fund moves into surplus. Similarly, though not so tightly linked to the pace of the economy, support payments to households defined to be in poverty tend to decrease as the economy grows.

These are "countercyclical" expenditures in two senses. The first is purely definitional. They go up when the economy goes down, and vice-versa, moving against the "cycle" of the economy. More importantly, they make a contribution to reducing the economic cycle. When the economy declines, some people lose their jobs and with in all or part of their current income. As a result, household consumption declines, reinforcing the initial contraction of the economy.

Countercyclical expenditures reduce the strength of the "multiplier" process in which contraction leads to more contraction. By their nature the expenditures contribute to deficits, and we should be very glad that they do. They also work the other way, reducing deficits and helping to turn them into surpluses when the economy expands.

To put the matter simply, deficits result from recession, not excessive expenditure, and they decline and turn into surpluses when the economy expands. The chart below makes this interaction obvious, showing the positive relationship between the US federal fiscal balance and the civilian unemployment rate.

**US federal deficits increase when unemployment rises**  
(Percentage of GDP and the unemployment rate, 1955-2011)



There is more to the countercyclical story. When a country has a progressive tax system it means that the percentage of income paid as taxes increases as household income increases. This must mean that when the economy contracts, the tax share for households declines. As result household income after taxes ("disposable income") falls less than total income, and household consumption falls less than household income.

Even in the United States after all of the Reagan and Bush tax breaks for the rich the tax system retains a small progressive element. This results from "deductions", for example, those that households claim for dependents. As income falls, the part of household income that is subject to tax also falls.

We can identify three processes that link the health of the economy to public sector finances. First, government revenue comes from taxes on the economy's output. Second, in the aggregate taxes are progressive, which means that they decline more than

incomes declines and vice-versa. Third, a substantial portion of public expenditure is counter-cyclical, kicking in when the economy contracts and switching off as it expands.

These three processes lead to a very important conclusion. The public sector goes into deficit just when we need it to. Deficits are a good thing and we should welcome them. If a government attempted always to maintain a balanced budget, this attempt would make recessions longer and deeper by reinforcing economic contractions.

Public sector deficits are the automatic by-products of countercyclical processes that act to reduce recessions. How should we assess the uncontrollable enthusiasm in the United States of almost every Republican politician, and the lukewarm acquiescence of the vast majority of Democrats, for expenditure cuts to balance the federal budget? Why is fiscal austerity the apparent policy consensus in Western Europe? It is the triumph of ideology over rational policy, the imposition of fantasy upon reality.