

A NOTE ON DEFICITS AND FUNCTIONAL FINANCE EXPENDITURES

Louis-Philippe Rochon, Associate Professor of economics, Laurentian University
Mario Seccareccia, Professor of economics, University of Ottawa

For the past year, financial markets have been in turmoil, and in the last two months in particular, we have seen our financial markets brought to the brink of collapse. Our economies are now heading toward a pronounced recession, and possibly a world recession. Not since the Great Depression has so much been at stake.

Two questions dominate the current crisis: (1) how did we get here; and (2) how do we get out of it? These are not easy questions to answer. Markets are complicated and surely a myriad of elements contributed to the current situation. Nevertheless, we believe we can identify some of the fundamental explanations of how we allowed ourselves to get into this mess.

Undoubtedly, several factors contributed to the present crisis, but many years of bad economic policies caused by mistaken economic theory have certainly contributed to the present situation, policies that if repeated will eventually result in the same sequence of events all over again. These policies encouraged the “casino” behavior of financial markets and institutions and the effective institutionalization of deflationary policy bias was bound to have its impact eventually. We address these issues below.

Inspired by Chicago economist Milton Friedman, and championed by Ronald Reagan, Margaret Thatcher and Alan Greenspan, among others, policy makers sought to deregulate financial markets, both domestically and internationally, believing that only markets, not elected governments can guarantee the welfare of all citizens. At the root of this ideology, is a fundamental mistrust of governmental institutions. Policies were tailored that limited the role and scope of the state in economic affairs.

Such policies included the deregulation of markets where firms and financial agents sought greater profits by searching for increasingly fragile and risky financial instruments. The subprime mortgage market is symbolic of this transformation. Banks were no longer required to hold a loan for the life of the asset. Rather, it could sell it off to a third party a month later, relinquishing any responsibility for its profitability – or lack of it. To this end, these assets were bundled up with others and passed on to other institutions, as safe and secure assets, of course with the blessing of credit agencies who gave them their stamp of approval. We all are painfully aware of what followed.

Second, the boom in the American economy was largely consumption-led, fuelled by borrowing and credit cards, which raised the average level of indebtedness of Americans substantially. With the end of the housing bubble, this trend could not be sustained and consumption fell

substantially. In Canada, consumption was also very high and so is average indebtedness, although Canada did not experience a housing bubble to the same extent as the United States.

Since August 2007, policy makers in the US, UK, Canada and elsewhere have adopted a series of policies that, so far, have had little impact in stemming the tide of economic pessimism. They have reduced interest rates, given out stimulus packages that internationally add up to trillions of dollars, and adopted a historical bailout plan worth more than \$750 billion, to come to the financial rescue of US financial institutions. Recently, policy makers in the US, the land of free enterprise, have agreed to an unprecedented policy: the (partial) nationalization of banks.

While we must welcome many of these initiatives, they are proving too little too late. In Canada, in particular, our government seems reluctant or unable to acknowledge fully the depth of this crisis and to recognize what is needed to ensure economic growth, a better distribution of income, and prosperity for years to come. It seems still to be committed to a *laissez faire* solution, such as that of relying on its past budget surpluses as if their mere existence will somehow cushion Canada from a destabilizing international crisis. Our federal government seems oblivious to the fact that its commitment to budget surpluses makes the situation worse by withdrawing needed expenditures in communities that are facing growing problems of unemployment and declining incomes, and by incrementally removing from financial markets the very low-risk assets (government bonds and Treasury Bills) in which worried investors can seek refuge, and are therefore desperately needed.

What are the possible policies that will lead us out of this current mess? In the current circumstances tax cuts, while they certainly put money in peoples' pockets may not be the preferred way out. This is for two reasons. First, since Canadians are already too indebted, tax cuts might not contribute much to the growth of the economy, as much of the money may go toward reducing their debt load. This is a good thing in itself but would not contribute to higher growth. Second, current problems are likely too deep-seated to be cured by consumption-led growth alone. Therefore, governments should abandon their obsession with budget surpluses and should seek to deficit-spend in a variety of useful ways, some of which we address below. Of course, the once taboo idea of deficit spending is already finding some support in unaccustomed quarters in the current crisis. Even Mr. Flaherty described balancing the fiscal books as "misguided" in current circumstances. But we do not think this goes far enough. In essence, Mr. Flaherty is only partly right. We believe that the mindless mantra to "balance the budget" is not only misguided in times of recession, but at all times.

Two arguments drive our reflections:

- 1) Mainstream economic policies are what led us to this crisis and should be rejected: the age of neo-liberalism is dead, and we need to turn to proven policies of growth.
- 2) Government policy can have a positive role to play in fostering economic growth. Since at least the 1930s, Keynesian-inspired economists have been calling for a greater involvement of

the governments though activist fiscal policy, and warned that it was too costly and too dangerous to leave it all to the markets.

As for deficits and government spending, there is a very simple accounting principle, to which, the vast majority of politicians in Canada who continue to decry budget deficits seem to be oblivious. This simple principle, based on double-entry book-keeping, points to the fact that if someone is spending more than s/he receives, thereby accumulating a debt, someone else must be receiving more than s/he spends, thereby accumulating assets. The same can be said across broad sectors of the Canadian economy. If the public sector spends less than it receives (as has been the case since the mid 1990s in Canada), the private sector as a whole must be spending more than it receives reflected in growing household indebtedness. Hence, in an economy that must grow just to absorb the growing number of people entering the labour force, someone, or some sector, must go into debt just to generate the needed overall demand to prevent the unemployment rate from rising. In other words, if we want our economy to grow, someone, somewhere, must be willing to go into debt. This is a simple accounting fact. Hence, it cannot be true that deficits are “bad” in themselves. Rather the question should be: which sector, in fact, will be willing to go into deficit, and under what conditions *should* one run a deficit?

There is a long-standing principle that comes to us from the crucial intellectual struggle that took place during the Great Depression of the 1930s. When the private sector is no longer willing to go into debt, because of fears of the type that are now plaguing the US and other economies, it is actually incumbent on the public sector to go into debt, to prevent the economy from spinning into a dangerous downward spiral of deflation and depression.

What type of public deficit spending however? We believe that it should be a spending policy that seeks to target a sufficiently high level of growth, sustains a healthy labour market outcome of high employment for all Canadians, and generates desirable public goods that will last long into the future. These expenditures ought to be primarily for the purpose of building up various forms of “social capital” than support private sector productivity, including “human capital” formation via training and education, as well as policies to support and protect our economies in other ways, for instance, from the growing problem of environmental degradation.

It is useful to divide fiscal expenditures into two components: (1) day-to-day current operating expenditures, and (2) public investment (capital expenditures). Much as a household might go into debt to make major investment expenditures such as buying a house or purchasing a car, but still try to live within their means in putting “bread on the family table,” politicians should stop confusing the two when it comes to government expenditures. If promoting balanced budgets, they should distinguish between these two types of expenditures (actually already standard accounting practices adopted by the Department of Finance and Statistics Canada), and advocate as a *long-term* goal the balancing of the current operating account only.

On the other hand, just as households and business do not hesitate to go into debt when engaging in *private* investment, public investment should similarly not be constrained by a “pay as you go” mentality. Rather public investment should constitute a key element of a growth strategy. Much as in the heydays of the 1950s and 1960s when public investment constituted a much higher share of total government outlay than it does today, we believe that expenditures on public capital should be increased and ought to make up a far more important component of government expenditures. For instance, using the European Maastricht Treaty as a point of reference, even that restrictive Treaty allows member-States to attain a deficit/GDP ratio of 3%, which can be exceeded during times of severe crisis. While we do not believe that Canadian governments should ever place themselves in such a formal straitjacket, in Canadian terms even Europe’s 3% rule would mean, for all levels of governments, a deficit of close to \$45 billion for the current fiscal year. This is a far cry from our continued commitment to balanced budgets regardless of whether it is to pay for government groceries or for public capital expenditures!

As with any private investment, the returns to public investments are not always immediately apparent, but only become so many years into the future. These consist of investment in education and health care, but also public infrastructure such as roads, bridges, as well as in measures to clean up the environment. These investments are the key to our future economic growth. Governments should therefore always be prepared to run a deficit to ensure a sufficiently high level of public investment. Not only do they contribute to higher economic activity, but they translate into higher private profits: they are really a transfer from the public to the private sector that will ultimately enhance the latter’s future productivity.

This conclusion was recently echoed by Robert Rubin and Jared Bernstein, in a comment published in the *International Herald Tribune* (November 3, 2008). Coming from two very different intellectual perspectives (indeed, as Rubin himself admits, he is closely associated with fiscal discipline), the authors conclude that “our economic future also requires public investment in critical areas like education, health care, energy, worker training and much else. ... But the idea that we can’t be fiscally responsible while undertaking public investment at the same time is a myth.”

Capital expenditure deficits are not a scourge that we leave to our children and future generations, which they have to pay for through higher taxes. Rather we leave them a better health care system, a better social safety net, a better educational system, better bridges and roads, and a cleaner environment. By investing in the future, these public investment expenditures also ensure economic growth and lower unemployment by stimulating private sector initiative, and translate into higher future tax revenues that would largely offset current expenditures. There should be no need to raise tax rates in the future.

There is no need for fear mongering about the size of the national debt. Without deficits, in fact, the system is condemned to stagnate. Following the high budget deficits that Canadian ran for about for about two decades until the mid 1990s, taxes were actually seen to fall and not rise!

In fact, most of the deficits of that era were largely incurred because of the high cost of servicing the debt as a direct result of the high interest rate policy of the Bank of Canada in fighting inflation. Today, however, both inflation and interest rates are very low, large deficit and fiscal investment are more easily manageable.

What about in the future? It is true that higher deficits in the future would contribute to high debt servicing, but by increasing the share of public investment in overall expenditures, governments would also contribute to higher rates of growth, higher tax revenues, which would offset such servicing cost – just as do households and business when they take good investment decisions.

Governments should be practical in the approach to fiscal policy, and public expenditures should be based on their functionality (that is their ultimate effect on the real economy) above all. Balancing the books in the purely financial sense should not be the bottom line. Rather, governments should identify priority areas of investment spending to help the economy achieve its potential. We argue it is time to replace a consumption-led strategy accompanied by high personal indebtedness, with a public-investment-led growth strategy that benefits everyone.

Fletcher Baragar, Associate Professor, University of Manitoba

Manfred Bienefeld, Professor, Carlton University

Ronald Bodkin, Professor Emeritus, University of Ottawa

Hassan Bougrine, Professor, Laurentian University

Robert Chernomas, Professor of Economics, University of Manitoba

Robert Dimand, Professor, Brock University

Gilles Dostaler, Professor, Université du Québec à Montréal

Bernard Elie, Associate Professor, Université du Québec à Montréal

Andrew Jackson, National Director of Social and Economic Policy, CLC

Marc Lavoie, Professor, University of Ottawa

Joelle Leclaire, Assistant Professor, SUNY College at Buffalo

Jean-Guy Loranger, Professor, Université de Montréal

Fiona MacPhail, Associate Professor, University of Northern British Columbia

Mike McCracken, President, Infometrica

Margie Mendell, Director, Karl Polanyi Institute of Political Economy, Vice-Principal, School of Community and Public Affairs, Concordia University

Pierre Paquette, Professor, Royal Military College of Canada

Corinne Pastoret, Assistant Professor, Laurentian University

Toby Sanger Senior Economist Canadian Union of Public Employees

John Smithin, Professor, York University

Brenda Spotton Visano, Professor, York University

Jim Stanford, Economist, Canadian Auto Workers