POLITICAL ECONOMY OF THE GOVERNMENT DEFICIT

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Introduction

Proposals for reducing the budget deficit have become the centre piece of economic policy discussions in recent times. The case for deficit reduction is typically couched in terms of such desirable ends as higher investment, increased competitiveness, and higher employment. Deficit reduction has also been advocated as a means to reducing inflation. In other words, deficit reduction is seen as a cure for, and by implication as the cause of, whatever problems the capitalist system comes to face.

Proposals for deficit reduction need to be put into perspective with a view to clearing the misconceptions surrounding the issue. It is also important to understand why different groups with divergent interests come to support the same proposal. We ask essentially the same question Kalecki asked fifty years ago:

> The businessmen in the slump are longing for a boom; why do not they accept gladly the 'synthetic' boom which the Government is able to offer them? (Kalecki, 1943:138)

In the Australian context the pursuit of deficit reduction gets support from the labour movement. Why would the labour movement, which stands to lose from the deficit reduction in the form of reduced public employment and cut in social wages, support such a proposal?

We pose the problem in a simple model of income determination that incorporates income distribution parameters. We then interpret the model in a simple growth context with stagnant investment and identify the set of problems, the main one being the loss of competitiveness, that emerge as a result of deficit financing to maintain profitability and employment over a period of time. These findings are then used to cast light on the apparent contradictions involved in the above questions.

A Basic Framework

To establish the basic principles of income determination and income distribution, consider initially a simple competitive economy with no government that produces a single good which can be used for consumption or investment[1]. If we denote by W the aggregate real wage bill, Π aggregate real profits, by Y total real income, C total consumption, and I total investment, we have:

$$Y = W + \Pi = C + I \tag{1}$$

as an identity. Introduce the assumption that workers consume all of their income while capitalists save all of their income, i.e. W = C. It follows that profits must be equal to investment.

Let π denote the share of profits in unit net output, so that $\Pi = \pi Y$ or $Y = \Pi/\pi$. Since total profits is equal to investment, we get the familiar saving/investment equality in a form that incorporates income distribution parameters[2]:

$$Y = I/\pi \tag{2}$$

Income will be pushed up to the point where profits are just equal to the given level of investment, taking into account distributional factors.

1 This framework is well established, and is included here for the sake of completeness (see Kalecki, 1971 and Minsky, 1986).

2 Note that ΠY (share of profits in total income) is also equal to total savings, given that savings derive only from profits.

Thus, given the level of investment, income will expand to the point where the share of investment in income is just equal to the share of profits in output, Π.

In (2) there is an implicit relationship linking income and income distribution parameters. We need to introduce additional structure into the model. Obviously if we fix any two of the variables in (2), the third can be determined by the model. Choosing a particular set of variables is referred to as choosing a closure for the model. A number of alternative closures is chosen as model results are ultimately shaped by the closure rule adopted.

First consider investment. We know that investment is equal to total profits. The question arises whether it is the investment decisions of capitalists that determine their income (profits) or vice versa. As Kalecki argues (Kalecki, 1971:78-9), capitalists can decide to spend more, but they cannot decide to earn more, their investment decisions determine profits, and not vice versa. The entire model structure thus becomes dependent on the level of investment. We shall take investment as given, but the possibilities of feedback from other components of the model will be considered.

Given the level of investment there are a number of ways to determine Y and Π. First consider the Ricardian tradition. Classical writers, most notably Ricardo, considered a given real wage rate fixed at subsistence level. Given the real wage rate, we also know the share of profits in unit net output, as the share of two income groups must add to unity. It is then possible to determine income from (2) corresponding to a given level of investment. Admittedly, the fixing of the real wage rate at a subsistence level is now somewhat simplistic. What matters is the classical idea that income distribution is determined independently from demand and income determination and enters as an input into their determination.

Keynes took a different path. He fixed the ratio of investment to income. The ratio of investment to income is nothing other than the aggregate savings ratio (s) that appears in his well known multiplier relationship $Y = I/s$. Given I/Y, (2) will solve for share of profits and thus income distribution. As a result of our assumptions, the share of

profits is simply the aggregate savings ratio, i.e. $\Pi = s$. Thus, in the Keynesian system income determination is given prominence over income distribution[3], but it shares with the classical model the property that investment is given an independent role in determining income and income distribution. In other words investment is the driving force in all of the models considered so far. It is possible to consider the model at full capacity, so that Y is fixed by capacity considerations in the short run, and continue to maintain the independent role of investment. In this case income distribution becomes the adjusting variable.

We shall stick with the classical tradition without subscribing to any particular way of determining income distribution. Recognizing that income distribution is the outcome of complex social phenomena, we remain agnostic about its determination and treat it as a parameter that is susceptible to influences from a variety of sources. This way we retain a degree of freedom and discuss such influences whenever appropriate.

The Deficit

The framework has to be modified to incorporate the government sector, and alow an open economy. In an open economy with government sector, (1) becomes:

$$Y = W + \Pi + T + M = C + I + G + X \qquad (3)$$

where T = taxes, M = imports, G = government expenditures, X = exports W and Π now measure after-tax incomes. Maintain the assumption that all wages are consumed and all profits are saved, it follows that:

$$\Pi = I + (G - T) + (X - M) \qquad (4)$$

3 Income distribution considerations do not appear explicitly in the usual Keysian income determination models. The dominance of Keynesian macroeconomics is largely responsible for the absence of any income distribution considerations in mainstream macroeconomics where the rate of profit hardly gets a mention.

After-tax profits is the sum of investment, the government budget deficit and the trade balance. As a result (2) is modified to:

$$Y = \{I + (G-T) + (X-M)\}/\pi \qquad (5)$$

From (4) and (5) it would appear that an increase in the budget deficit would add, on a dollar for dollar basis, to profits and, with a constant Π, would thus increase income. This is the `synthetic' boom the government has to offer. We have to ask: is this really true? It is precisely the capitalist camp, which is supposed to benefit from deficits in the form of higher profits, that is calling for a reduction of government deficits. Moreover, their calls increasingly gain silent support from the labour camp, which might lose from deficit reduction if it means reduced social wages.

A better understanding of the question at hand is gained when we consider a growing economy. Let ß denote the capital-output ratio, i.e. units of the capital good required per unit of net output. Since the economy starts a new period with a higher stock of capital stock by an amount equal to the investment undertaken in the previous period, I_{t-1}, the capacity of the economy increases by $(1/ß)$ or I_{t-1} in any period t. It follows that:

$$g_t = (Y_t - Y_{t-1})/Y_{t-1} = (1/ß)(I/Y)_{t-1} \qquad (6)$$

where g_t is the growth rate of capacity output. If we assume that full capacity is always maintained, it is also the actual growth rate of the economy. Alternatively, if investment remains stagnant in real terms at level I in all time periods, it follows from (6) that the growth rate will fall as (I/Y_{t-1}) will be falling in each period as income increases, irrespective of the initial share of investment in income. This means that, even to maintain a given growth rate with a constant technology (ß), investment must grow at the same rate as income so that the share of investment in income remains the same. For the growth rate to increase, investment must grow faster than income.

Dividing (4) throughout by income we get $\Pi/Y = \pi = (I/Y) + (G-T)/Y + (X-M)/Y$. Assuming further that $M = mY$, m being the marginal propensity to import, we obtain:

$$\Pi = (I/Y) + (G\text{-}T)/Y + X/Y - m \qquad (7)$$

If I/Y falls as a result of income growth with stagnant investment, (7) implies that the share of profits in income will also fall, unless either the budget deficit or exports increase as a proportion of income to match the fall in I/Y. If X (exports) also remains constant or does not increase as fast as income, the budget deficit must grow faster than income to maintain the share of profits, given that X/Y will also be falling as income grows. Thus, relying on budget deficits to maintain profitability will result in a secular increase in the share of the deficit in income. While this is happening the general outlook of the economy is deteriorating: the economy is slowing down in growth terms, and investment and exports as a proportion of income are both falling.

Such a tableau is typically the *result* of maintaining the growth rate of income in the face of stagnant investment and not the *cause* of it. This point is frequently misunderstood. A government advisor is reported to have said on the occasion of his recent appointment:

> I think very few people understand that a dollar on the Budget deficit is a dollar off national savings, in exactly the same weight as a dollar saved less by households. [4]

In our model national savings is given by $\Pi + (T - G)$, i.e. the sum of private savings (profits) and government savings[5]. From (4) it follows that national savings is also equal to $I + (X - M)$. The conventional argument boils down to the proposition that an increase in budget deficit will be met by a reduction in either private investment or a fall in exports. This is of course the Treasury view that Keynes argued against in the thirties. It is noteworthy that such assertions are usually made after a period of stagnant investment. As we have already argued such a period will always be associated with a falling national savings as a proportion of income, together with an increasing deficit as a proportion of income. But this does not mean that the rising deficit is

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4 Comments by Dr. V. Fitzgerald as reported in the *Australian Financial Review*, April 5 1993.

5 We are assuming here that government investment is included in I so that G includes only current expenditures.

the cause of falling savings. On the contrary the root of the problem is the lack of investment at a sufficient rate. Yet, a lot of people share the view that reducing the deficit is a precondition for increasing national savings.

One obvious case in which the deficit would reduce national savings is when the deficit grows faster then is required to keep the share of profits constant. From (7) we see that either π increases or I/Y and/or X/Y falls. An increase in π with a given money wage structure is possible only through inflation. If wage earners do not or cannot resist the fall in real wages through mild inflation, then π can increase. But such a process cannot be continuous. If pushed beyond reasonable limits it will incite higher nominal wage claims and will be the cause of an accelerating inflationary process. Once real wage resistance takes hold so that π cannot increase any further, I/Y or X/Y, i.e. national savings, will have to fall. The more likely candidate in the short run is exports because of loss of competitiveness that accompanies the accelerating inflationary process. Depending on the response of the monetary authorities there is also the possibility of a reduced investment as a result of a recession induced by higher interest rates. In short, using deficit spending to increase the share of profits is not possible beyond certain limits that depend on the underlying social process through which income shares are determined. However, this case is certainly not a cause for concern in the current recession. In fact, worries are expressed over the medium term, when investment picks up, and it is argued that the deficit should be reduced over the medium term to make room for increased investment. But if investment is going to pick up despite the current level of the deficit, the deficit cannot be the cause of low national savings. Such statements only demonstrate the state of the confusion surrounding the issue.

Obviously the whole issue cannot be explained away as the outcome of misunderstanding or confusion. There are still limitations to the size of the government, even if the government deficit does not outgrow income to such an extent as to incite an inflationary struggle over income shares of workers and capitalists. The counterpart to budget deficits over a long period is the accumulation of government debt in the hands of those who save, capitalists in our model. Debt

accumulation brings with it the problem of debt servicing. Now, assuming that there is no net borrowing from abroad and that all government deficit is financed by borrowing, we have the following flow of funds equivalent of (4):

$$\Pi = I + \Delta B \qquad (8)$$

where ΔB is increase in government bonds, i.e. net borrowing by the government, in a given period. Equation (8) implies that capitalist acquisition of assets, new capital(I) and government debt instruments, must be financed out of new sources of funds, i.e. profits (savings). This equation, an accounting identity, is itself a source of much confusion and is responsible for assertions to the effect that government deficit(borrowing) crowds out private investment. On the contrary, net borrowing finances itself because the government deficit generates just enough profits to purchase the new debt issue which is equal to the deficit itself, i.e. it adds to the both sides of the equation. The other portion of debt servicing, namely repayments on retiring debt in a given period, will be met by new borrowing so that it does not involve any drain on capitalists funds. The role of monetary policy in this setting is to ensure a stable value for (or a fixed interest rate on) the government debt. In this way any possible feedback from government deficit financing to interest rates is prevented. This was, broadly, the policy setting in the post-war period until the early 1970's, and it is an essential ingredient of the mechanism of the synthetic boom the government can generate. However, such a setting becomes difficult to maintain over time, especially when accompanied by a stagnant investment.

First of all, debt servicing involves a redistribution of funds among capitalists. Those who buy new issues and those who receive repayments or interest are not the same people. At times of rapid accumulation and confidence, as was the case in the post-war boom period, this process does not pose problems. With investment and thus profits both high there is always demand for safe and liquid assets, and government debt instruments satisfy this demand without concern. But through time the size of the debt stock increases and with it the amount of redistribution of funds. Those capitalists who have accumulated government debt instruments rather than direct claims on

profits, will be demanding a comparable return on their placements. In other words, there develops an increasingly distinct claim on income other than wages and profits. The price at which the government can borrow, i.e. the interest rate, will come under pressure. However, government liabilities are valuable only if the government can meet its payments commitments. Obviously the government debt is default free, at least for the developed economies, in nominal terms. With increasing debt stock and continuous deficits the ability of the government to meet its interest obligations out of current revenues may diminish. This would increase the perceived risk of an inflationary finance and/or an ever increasing debt growth to finance debt servicing. As a result, the quality of the government debt and with it the "credit rating" of the government would decline, which means that the market interest rates on government debt would tend to increase[6].

Under such circumstances the traditional strategy for monetary policy, i.e. that of maintaining the value of the government debt, becomes impossible without an inflationary monetary expansion. Such an inflationary monetary expansion would reflect the struggle over income shares, that between rentiers and others. Moreover, as a result of financial liberalization and ensuing integration of financial markets, the pressure on the authorities intensifies. It becomes very difficult to confine movements in the foreign exchange market while at the same trying to maintain a particular interest rate structure. Eventually authorities give in, and leave the valuation of the government debt, as well as the valuation of domestic currency, to market forces[7] . In short, as the size of government debt increases relative to income, and as restrictions on financial institutions are lifted, the government debt cannot be serviced without impinging on the relative price structure, including interest and exchange rates. As a result the government deficit comes to be seen as the cause of unfavourable

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6 H. Minsky, among others, has stressed the monetary nature of a capitalist economy and the financial aspects of government spending (Minsky, 1986)

7 In Australia the dollar was floated and most foreign exchange controls were removed at the end of 1983. At the same time, the system of selling government debt instruments was changed. In contrast to the old system, authorities would establish the amounts of bonds to be sold with the price determined by the market (See Milbourne, 1990).

relative price movements within the economy. This is essentially the reason why some people believe that the government deficit reduces, dollar for dollar, the national savings.

The most damaging aspect of a period of stagnant investment is that it results in a loss of dynamic competitiveness. By dynamic competitiveness we mean the ability to develop the mix of the productive capacity of the economy in a way that makes it possible to produce tradeables in an evolving world. This contrasts with what may be called static competitiveness i.e. a shift of the composition of final demand (eg. as a result of devaluation), without transforming the productive mix of the economy. Competitiveness in the dynamic sense can only be gained and maintained through investment that is comparable in both quantity and quality to investment undertaken in the competing countries. As other economies are investing on a large scale and transforming their productive bases, a lack of sufficient investment relative to competitors will inevitably erode dynamic competitiveness. This means that the external balances of the economy deteriorates and results in an "unsustainable" external debt position. A new deficit, in addition to the government deficit, develops: the external deficit. As a result of the unsustainable "twin deficits", the credit rating of the entire economy, both domestically and internationally, is lowered and the pressure on key relative prices (interest and exchange rates) intensifies.

Two things must be noted about dynamic competitiveness. First, at a certain stage after a period of stagnant investment, the lack of dynamic competitiveness, and the low level of national savings, becomes a structural feature of the economy. The investment effort required to overcome this structural weakness increases. The prospects for sustainable growth and employment become increasingly poor and a sense of national crisis develops. The policy recommendations tend to converge, except for details and the speed of implementation. Second, gaining dynamic competitiveness means increasing national savings, since in a dynamically competitive economy investment and exports will be high. As such, calls for increasing national savings and becoming dynamically competitive coincide. In a competitive and integrated world, only a dynamically competitive economy is capable

of generating sustainable growth and employment. The `synthetic' boom the government has to offer, i.e. maintaining profitability and employment through deficit financing, becomes less of an option because of the understanding that it cannot be sustainable. The unions support the proposal for becoming dynamically competitive, which comes to coincide with increasing national savings, for the new, better paid and sustainable employment prospects that go with it. But the decision to invest rests with the capitalists and they blame the lack of savings for not being able to invest. They claim that deficit reduction is a precondition for increasing national savings and reviving investment. Having agreed to the need to increase investment, one becomes obliged to agree to the terms laid by those who can increase investment.

However, if a low level of national savings is the result rather than the cause of insufficient investment, why do capitalists insist on deficit reduction? Deficit reduction is not going to enhance dynamic competitiveness by itself. One obvious reason is the lower interest rate structure that is expected to accompany the deficit reduction. In this respect, for a small economy such as Australia, the possibility of a lower interest rate structure depends crucially on the interest rate structure in the financial centres of the world, as well as the state of the world economy. Unless there is a world wide lowering of interest rates and an improvement in the 'fundamentals' affecting the dollar, such as commodity prices, the scope for lower domestic rates is limited.

In addition, one has to confront the internationalization of the world economy. In fact the notion of a world economy itself presupposes the process of internationalization. This process involves, among other things, the emergence of corporations that set technological standards and plan production and distribution on a global scale. In such a world, competitiveness in the dynamic sense we have defined is not possible, without direct or indirect involvement of global corporations, especially for a relatively small economy like Australia[8]. From the point of view of these global corporations an individual economy is just a possible location for setting up operations. The situation is not much different

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8 These and related points are covered in more detail in Crough, Wheelwright and Wilshire (1980).

from that of a large domestic firm considering different regions within a country for setting up operations. As such, economies are judged on the basis of a host of attributes such as stability, education level of the work force, the state and sustainability of industrial relations, the state of infrastructure, and the state of external financial openness.

Capitalists believe or hope that reducing the deficit and restructuring government expenditure will help improve the attributes of the economy. The deficit reduction will target current expenditures and will involve direct or indirect real wage reductions and redundancies in the public sector. Public sector employees being one power base of the union movement, this will erode their power base and make it easier for transforming the industrial relations system in the economy. Coupled with increased unemployment, it will then become easier to reduce the level of real wages without resorting to inflation. Reduced wage costs in the production of publicly produced goods which are inputs to private business will help improve competitiveness. In addition other hand, it is suggested that government expenditure must be directed away from subsidizing unemployed workers or other forms of mass consumption to make room for expenditure on infrastructure and subsidizing private investment in some form.

Whether these changes will be enough to attract sufficient investment from the global corporations or to revive domestic investment is not clear. Compared to other countries they may not be sufficient and capitalists will not be able to go all the way in reducing living standards to low enough levels, because the support provided by the labour movement will be withdrawn long before such a point. Resulting confrontation may then retard the required transformation. The labour movement is supporting the drive for gaining dynamic competitiveness for the new and more secure employment prospects that go with it. If the pace of deficit reduction is fast and its impact on increasing dynamic competitiveness is slow, the union support will be withdrawn because of the prolonged burden on the workers that accompanies an initial recessionary period and cuts in social wages. On the other hand, if a gradualist approach is taken and the burden on workers is partly absorbed by the budget, as the government is trying to do, then

the deficit reduction will not proceed as fast as required for the transformation. In short, the social consensus for improving national savings through deficit reduction rests on a weak basis that depends on quick success. If, as is likely, the deficit reduction scheme fails to deliver fast enough, then the scope for its subsequent success will be reduced.

At the bottom line, the capitalist call for deficit reduction rests on a fundamental dislike of government spending policy for the reasons Kalecki noted fifty years ago (Kalecki, 1943). His point is that capitalists see large scale government involvement through deficit spending as undermining their social position, because it generates opportunities for workers to escape the social discipline imposed on them through their livelihood being dependent on the decisions of capitalists. Despite a stagnant investment, due to capitalists' decision, government can maintain profitability and contain unemployment, thus making it possible for the workers to escape the said discipline. Eventually the lack of investment produces a whole set of problems, and the capitalists regain the prominence they deserve. In essence without a surge in investment the economy cannot remain on a sustainable path of growth and employment. The need to restore business profitability and confidence gains widespread acceptance. Business starts arguing for "sound finance" on the part of the government as a precondition for reviving investment. The social function of the doctrine of "sound finance", to paraphrase Kalecki, is to make the level of employment dependent on the investment decisions of capitalists alone and thus to be able to have a bigger say in policy-making. More recently, similar considerations have been expressed by other researchers:

> Business is concerned with all costs, and with more than labour discipline it is concerned to keep open the field of action of capital. ... Once capital has conceded the right of labour and/or others to challenge its authority and prerogatives, there is no obvious stopping point....None of these groups - labour, consumers, environmentalists - is itself able to operate the economy or to police business to ensure compliance with legislation or agreements. All depend on the state bureaucracy for that. Thus, dismantling the state deprives popular

> movements of any means to enforce their will. (Nell, 1984: 234-235)

In short, through deficit reduction capitalists are seeking to shift the balance of power in their favour and regain control over government policy. Through the pressure resulting from the loss of dynamic competitiveness, they have even been able to rally support, even if indirect, from the labour camp. Even if deficit reduction does not deliver what is promised, and there is no obvious way that it can, the capitalist camp will emerge substantially strengthened from the process.

Conclusion

Using deficit financing to sustain profitability and high employment is not viable over long periods of time, especially in the face of stagnant investment. A whole set of problems, including the loss of competitiveness as a result of lack of sufficient investment, emerges through time. The deficit comes to be identified, incorrectly, as the cause of such problems. The symptoms appear in the form of a lack of sufficient national savings. The deficit reduction is presented as a necessary condition for increased national savings and an increase in investment and/or exports. As export growth in a competitive world is dependent on investment to be sustainable, the case for increased national savings coincides with the need for increased dynamic competitiveness. It is this fact that forms the basis of apparent support from the labour movement which stands to lose from deficit reduction but hopes to gain from the new and sustainable employment opportunities that go with dynamic competitiveness.

As for the capitalist camp, the appeal of deficit reduction is to be understood in Kaleckian terms whereby it is seen as an opportunity to tilt the balance of power on its side as far as the making of government policy is concerned. However, in public policy discussions it is put forward as the scientific response to pressing necessities emanating from the loss of competitiveness as explained above. Business has the clout of international capital behind their concerted

efforts towards gaining support for its cause. International rating agencies and other organizations constantly review the state of the economy and stress the unsustainability of the current state of affairs. The effects of these reviews are immediately felt in the financial markets in the form of a rapid loss of value of the dollar, increase in market interest rates or both, which gives added force to the arguments of the capitalist camp.

The recent New Zealand experience puts the argument into perspective, namely that the concern of capital is with "opening the field of action" rather than the deficit itself. In reviewing the New Zealand experience Easton writes:

> The financial sector is now telling us that such large deficits no longer matter because, so they say, the deficits are due to revenue deficiencies rather than expenditure excesses (shades of Reaganomics). One cannot but voice the suspicion that their past concern with cutting the deficit was really about destroying the welfare state, and when the 'cause' was due to business tax avoidance the merits of deficit financing became evident to them." (Easton, 1993: 159.)

The fundamental problem the union movement faces is that it has become too dependent on the government. The government has become the essential medium through which union politics is conducted, and this is what capitalists resent most. It lacks the ability to rally support from the wider community for independent policies of its own design. But the ability of a national government in a single economy to sustain the demands of the unions has been seriously hampered. This is because capital is mobile and in an integrated world economy it can escape the pressure from governments until such time as its demands gain prominence. A single economy, let alone its government, is no match for the international capital. Relying on a national government in a single country to gain on capitalists is not possible for prolonged time periods. As such, together with the government, a scaling down of the union movement, at least in its present form, seems inevitable.

Finally, if it is possible, to gain dynamic competitiveness by reducing the budget deficit and introducing accompanying deregulations in one

country, then other countries would do it too. That is what seems to be happening. We seem to have entered an era of competitive deficit reductions and deregulations, similar to those in the era of competitive devaluations for the sake of static competitiveness in the 1930's. It was not possible for every economy to become competitive, and as every major economy attempted to become so through devaluations, the collapse of the system accelerated. Today it may seem possible to gain dynamic competitiveness by way of attracting more investment from the international capital at the expense of other countries. But this cannot be sustainable. Gains from dynamic competitiveness can be reaped in full only if the world economy grows as whole. If an investment surge on a global scale does not come about while every major economy insists and succeeds in reducing its budget deficit, the system might face a similar fate it faced in the thirties. However, those who are preaching sound finance have learnt their lessons. They will allow for larger deficits than those they today find unsustainable, if the system is seriously threatened.

To sum up, the deficit reduction cannot be a solution to low levels of national savings and lack of competitiveness as popularly suggested, simply because the deficit is not the cause of these problems. The cause lies in the internationalisation of the world economy and the new division of labour that is in the process of being enforced on individual countries.

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