

## Principles or practical rules?

**A balanced budget: is it a moral obligation or a rule of thumb? To what extent should it steer an economic recovery during the pandemic caused by COVID-19?**



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Developments in the world economy, currently dictated by what we think we know about how the coronavirus is spreading, are proving worse than we thought just six months ago. In the West, the situation is especially serious in such countries as Italy and Spain. This is due to the

fact that the disease has been more virulent than it has in other places, since impacted sectors such as tourism are of great importance in these economies. Furthermore, both countries' governments find themselves with less leeway to counteract the effects on economic activity.

Indeed, the economic crisis today is a crisis of demand: private expenditure, in both consumer spending and investment, is much lower than what a full-employment economy would sustain. Making up for this deficit in private demand with public spending supposes, for now, an increase in the public deficit, which is already high in both countries, and, consequently, an increase in public debt, which is already at levels considered very high: 99% of GDP in Spain and 136% in Italy.

The helplessness felt by governments trying to cope with the economic downturn, especially dramatic in Italy and Spain, is also being experienced elsewhere. This has led us to wonder if governments are really as tied up as they seem at first glance. Mainstream economists answer yes, but there are those who assert that a public deficit's magnitude need not be an obstacle when it comes to maintaining an economy at close-to-full employment. I'll review three of those responses here, which I'll call optimistic, in order of complexity.

The first comes from William Vickrey. It starts with a simple observation by Keynes and many others: a decision to save is not a decision to invest; it is, in the first instance, a decision to spend less. Aggregate demand is thus reduced, unless it is offset by another decision, made by another, to spend more. When an economy is below full employment, families save more than companies plan to invest. An increase in public spending increases the disposable income of families and encourages them to spend more; the negative saving from the public sector compensates for excess saving from the private sector and brings aggregate demand to a level corresponding to full employment. The deficit recycles the excess of private savings, which materializes in public debt securities. As long as idle resources abound, unemployment, not the deficit, should be considered the priority of economic policy.

The second response is older: it is Abba Lerner's theory of functional finance. For Lerner, fiscal policy should not be classified as "sound" or reckless according to the criteria of the supposed mainstream, but according to the results obtained in the task that is entrusted to the government: "The first financial responsibility of the government (since nobody else can undertake that responsibility) is to keep the total rate of spending in the country on goods and services neither greater nor less than that rate which at the current prices would buy all the goods that it is possible to produce." It is perfectly legitimate, following that logic, for the government to finance its deficit by printing money as necessary.

The two proposals above offer up a great lesson: that the true objective of economic policy is maintaining employment, not balancing the budget. It remains to be seen whether or not a balanced budget is a necessary condition for full employment and whether an imbalance is an insurmountable obstacle to achieving it. There is no one-size-fits-all answer to the question, and the answers above aren't useful to us here.

Both Vickrey and Lerner have in mind an economy like the United States', one that tends to have, in its cycles, expansionary periods that allow the government to accumulate a surplus and reduce debt, if it wants. This way, debt is kept at a reasonable level and there is no need for it to grow disproportionately.

The U.S. economy, in addition, carries debt in the same currency that it issues, which excludes the possibility of a default and allows debt to be issued at reasonable interest rates. This second feature is not the case for members of the Eurozone, since the issuance of euros depends on the European Central Bank.

Paul Krugman can laugh at those he calls "bond vigilantes" -- those who react to an increase in debt levels by selling bonds, thus inflating their risk premiums -- because their actions have not been observed in the U.S. markets. But, on the contrary, southern Eurozone countries saw their risk premiums on debt rise to unsustainable levels during the 2008 financial crisis.

It seems, therefore, that a balanced budget is a necessary condition for giving our governments a certain freedom of movement. The proposal that follows offers a possible solution.

Recent work by Stephanie Kelton has made what's known as Modern Monetary Theory (MMT) fashionable. Her central thesis, as far as our topic is concerned, is that the real restriction on public debt limits is not a balanced budget, but inflation. It's the same point that Vickrey and Lerner make. Her claim is based on the fact that the state controls both the budget and the amount of money in circulation. Consequently, there is no practical limit to indebtedness as long as the economy does not reach full employment; only beyond that point does an increase in spending generate inflation.

The reasoning doesn't work in the case of individual Eurozone member states, but it does for the Eurozone as a whole. Under the current circumstances, public spending could be increased to cover the damage caused by the coronavirus because that spending could simply be charged to the account of the European Central Bank in euros. It could also be

financed, in whole or in part, if the corresponding debt were guaranteed by the Eurozone because the risk of default is, in my opinion, as remote as in the case of Krugman's bond vigilantes.

Kelton's thesis stands little chance of materializing as practical policy in the short term. On the one hand, the reaction in economic circles is similar to that provoked by Keynes's General Theory: "what's new is not true and what's true is not new." That reaction may become more nuanced in the coming months, as the initial thinking is translated into concrete proposals.

But perhaps the biggest objection that could be raised to the MMT-derived proposals is that public-spending capacity is concentrated wholly in the hands of elected politicians. This is the opposite of what was sought with the creation of independent central banks. One could argue that today's central banks are, largely, hostages of the financial sector, but there's no doubt that the concentration of power that would result from Kelton's proposals would meet with very strong resistance.

Let's return to the starting point: the objective of economic policy is the maintenance of employment in a market economy. A balanced budget is not a moral principle, nor a natural law, nor good or bad in itself. It is a rule of thumb, and, as such, exceptions must be tolerated. It seems crucial that, at least in the Eurozone area, current circumstances are considered exceptional ... and that we can act accordingly.

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