Only two cheers for fiscal prudence

JUST like citizens, a government ought to balance its books: so say politicians who want to appear responsible. The mantra these days is balanced budgets or, even better, budget surpluses, as in America and Britain. There are no longer many vigorous defenders of large budget deficits. Only the truly hard-pressed—an Argentina, say, or a Japan—should think of resorting to deficit spending. But hang on a second. A government’s bottom line is just a number. So how much does it really matter?

A traditional argument against balancing budgets dwells on the economic cycle. As an economy grows, and employment rises, tax revenues increase. When the economy turns down, fiscal transfers and other spending might be expected to rise, even as tax revenues fall. Far better, this argument goes, if governments balance the budget over the economic cycle rather than feverishly seeking to balance the books every year.

There are more fundamental problems over the idea of balancing the budget, however. Budgeting weighs the benefits of spending against the costs of raising taxes and carrying debt. The outcomes of these three activities—spending, taxing and borrowing—follow some simple rules, on the whole. First, the more a given government spends, the less benefit accrues from the last dollar spent. That is because the most pressing needs should be funded first. Second, the more a government taxes, the more painful it is for the last dollar to be taken from a citizen; the fewer dollars you are left with, the more each matters.

And third, the more a government borrows, the greater the risk that the last dollar borrowed will damage private capital markets: it “crowds out” private (and presumably more productive) investment competing for the same dollar. The future cost of repaying the last dollar borrowed, and the chance that the dollar will tip the scales towards default, also rise with the stock of debt outstanding. For this reason, carrying $2 trillion in debt is more than twice as harmful as carrying $1 trillion.

Assuming, for now, no political constraints, then totting up these costs and benefits over, say, a couple of decades would be a good way to decide what a government’s bottom line should be, and how it should be paid for. When public debt and tax-financed spending are relatively low, a deficit may be preferable. When taxes amply cover the legitimate functions of government, then a surplus can help provide against future deficits.

This model assumes that the cost of raising money increases with the scale of taxation and debt,
and that the additional benefits of spending decline. Fiscal restraint is therefore a virtue. Yet, from a purely economic standpoint, it will almost never be true that a perfectly balanced budget—or, for that matter, any one, fixed target for government accounts—will be the best solution.

That has not stopped America from considering a new balanced-budget act, or the European Commission from decreeing that the budget deficits of its members must not exceed 3% of their respective GDPs. Why? Well, rules of thumb are simpler than steering by complex calculations. Rules can discipline politicians, too. Without them, governments can run up a mess of deficits that is left to successors to sort out—recall the boom-and-bust policies of America and Britain in the 1980s.

Rules also ensure that changes in fiscal policy do not happen abruptly. Smoothness is good in quiet times—though clearly not when governments face an urgent need for spending, such as in wartime or in a period when tax collection would be particularly painful, such as during a prolonged slump. Even in less extreme situations, one size is unlikely to fit all, as Europe’s fiscal limits are meant to do. And well-intentioned budget rules can have another perverse outcome: they tempt politicians to fudge the numbers.

**Taking the long view**

Rules or no, politicians tend to act for the next election when it comes to budgeting. They try to push the burden of repaying debts far into the future. And long-term threats to fiscal health, such as the demands of an ageing population or structural impediments to the economy, can get ignored in the process.

In Japan, for instance, attempts to jump-start the economy through heavy deficit-spending have fallen flat. There is neither sufficient monetary easing nor enough structural reform to accompany the stimulus, and investment has failed to recover. America makes the problem still clearer. Given the huge predicted growth in entitlement programmes, mechanical increases in spending will, from the next decade, push the country deep into debt (see chart), if nothing is done.

Saving its surplus to pay off future debts, if that were politically and economically feasible, would keep America in the black for an extra 12 years. Washington is committed to reducing federal debt, but little enthusiasm exists for saving now against debts to be incurred in future. The time available for phasing in reforms of costly programmes such as Social Security and Medicare is thus half as long as it might otherwise be. Yet the alternative, raising taxes again and again, is hardly more attractive.