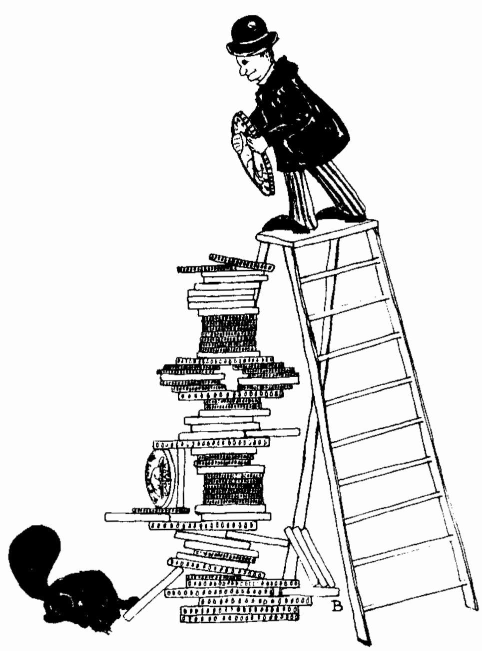
FISCAL RESPONSIBILITY AND GOVERNMENT SPENDING: THE SOCIO-POLITICAL IMPACT OF THE BALANCED BUDGET

By Lawrence Harris

Periods of inflation always bring cries for fiscal reform, particularly when government is a large contributor to the problem. This article argues that a balanced budget is not the real issue. Instead, government spending must become much more efficient, as an effective part of countercyclical policy. And this must happen before an irate public forces balanced budgets or other measures which may not be ideal under the circumstances. The argument applies with equal force to federal, provincial and municipal governments.

Fiscal policy occupies a tremendously large space of western political economy. Any discussion of fiscal policy ultimately embraces not only the questions of what mix and manner of policy is to be applied, but also the issue of how much government — or how much government activity — is appropriate or desirable in a given economy. Sometimes the latter issue is a matter of preference or taste; often, a result of habit or tradition — in a word, inertia. But there are choices to be made, which are guided in large measure by obvious and conclusive economic indicators. And yet, economics will always call into question all policy, to the extent that various schools of economic thought differ on the methods or assumed effectiveness of government participation and intervention in the economy.

An introductory paper can hardly solve the modern economic debate, which is as much alive in the periphery of government as in the core of academia. But some things can be taken without doubt. First, just by its very size, the government budget affects the economy; second, the skillful management of government finances



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can have positive effects, and always has significant effects, despite arguments over the ideal methods of economic stabilization. Within these pages it is possible to look with a critical eye at various aspects of government finance and fiscal options, and perhaps align these into better focus and perspective, pointing out some of the connections and their implications. At best, questions can be voiced and thought stimulated; at worst, balanced budgets will never be regarded as ends in themselves!

In speaking of government budgets, it is government spending that is primarily under discussion. At all levels of government, spending can be a counter-cyclical tool of stabilization policy. Two notions, however, must be separated. First, spending for the provision of services, and second, spending for the sake of counter-cyclical stabilization. It is in the former context that discussion of "public versus private" is appropriate. In the second case, the wisdom of a balanced budget may be examined. From the mixed economy standpoint, the first case is both an economic and normative question of whether to participate in various sectors of the economy. The second is a matter of extent. But from a macroeconomic standpoint, the scene is reversed: large government budgetary clout is assumed, counter-cyclical fiscal action is desired, then programs are designed as a means of putting money in people's pockets when times are tough or as a means of reducing aggregate demand when the economy is overheating.

Looking first at the service-provision aspect of government spending, many basic assumptions may be called into question, for we must ask by what mandate are government services — from police to welfare to broadcasting — provided. We can look back to Hobbes and Locke to trace the guardianship of the social contract. Through the centuries we can see government as protector, as coordinator — order achieved and maintained by its power of legitimate authority and right of expropriation. Government becomes a builder; in Canada, the railway.

Government is a centralizing force: the fountainhead of national policy (when there is a national policy) and the dispenser of future justice through its function of law-making. It becomes a force to be lobbied: an external spokesman, a domestic referee somehow presumed to coordinate interests, real and imagined, of a myriad of different collectives acting on their own behalf or on behalf of others.

Over the years, as western commerce and society have progressed, governments have taken larger roles in developing the infrastructure of the economy and in standardizing social conditions across the nation. In a field where generalizations are suspect, two may be put forth with conviction, which apply as well to municipal and provincial governments as to the federal. They are the advent and development of a mixed economy, and a deepening preoccupation with human rights and their social implications. The provision of government services in Canada, at all levels, somehow falls under one of these rubrics or the other. The first may be understood as economic and the second as normative motivation.

Project evaluation of undertakings in either area is by nature difficult. Concepts of public project evaluation have to be different in order to evaluate the joint-cost or anoprosthetic demand peculiar to the projects that economics suggests lie in the exclusive realm of government. Of course governments involve themselves in private-cost-structure-type projects as well, which we conclude is the result of a normative preference for government activity. But it is a false assumption to think that government participates in the economy because it can do something "best". Often its efforts are counter-productive if we would take the care to face up to penetrating economic analyses. Government enterprise is usually less than optimal, from airport design to postal service, items which seem to be of infrastructural nature but could be managed by private entrepreneurs under license, thus retaining the expediency of government coordination and the efficiency of private cost recovery.

Most government spending of the "service" type then must be normative in nature. This explains the ever-increasing array of social welfare expenditure, from make-work projects through pension plans to health insurance. Normative expenditures do not require an economic rationale *per se* — we assume that relevant economic considerations have entered into the decision-making process that produces normative or value preferences. In a democratic system normative policy can be sustained as long as it is simply the wish of the electorate. But government responsibility to parliament may not be sufficient to expose the folly of certain programs. The increasing opt-out rate from provincial health insurance schemes cannot be ignored; it is a signal that something has gone wrong between the wishes of the people and the action of the government. Whereas with infrastructural type programs there is always some economic evaluation available in times of doubt, normative spending can only be ratified through the ballot box. We have seen in the trend to "neo-conservatism" in general and the tax revolts in California in particular that there is some desire for less of a "mixed" economy in most areas, but particularly in sections where spending, under the terms of this paper at least, can be described as normative. Many people now want to reserve their right to choose among alternatives to public pension plans, health insurance, unemployment insurance, schooling, and many others of the services that have been profoundly assumed to lie in government domain. Why? People are not convinced of the efficacy of government programs, and, more poignant on a continent where democracy has flourished, they wish to retain individual rights which include the option to worry about your own future in times of distress.

Few people would opt for a total withdrawal of government services; but many make the point that the truly necessary and efficient programs will survive anyway and these programs would receive strong support from the population. Perhaps we tend to worry that a rush of individualistic withdrawal would leave the poor homeless and the hungry starving. But can we really be sure that this must happen? Many people feel that bureaucracy is so large that it is hard to tell just what effect it really has. Underneath, perhaps things would not degenerate as quickly as we think or are led to believe. Perhaps, too, the moral fabric of society is being strengthened by a hesitant skepticism towards systems and institutions. This might not allow human conditions to decline as we might expect.

So far we have looked at the spending side of government in the economy. We have questioned the art or act of spending in itself — not that all art is bad, but all is open to critical acclaim! Let us now offer something on how this spending is financed, since this is the constraint that necessitates every evaluation.

Governments, like individuals, can earn money or borrow it. But unlike individuals, the tax money that governments "earn" from the provision of services is enforced — but not tied to the amount or value of services that taxpayers receive. Thus there is no basis in law for fiscal equality among individuals. This fact is reviving a controversy that questions the justice or morality of cross-subsidization. In a word, "user-pay" is becoming a contentious issue in tax-revolt climates. But a second factor, already mentioned, is also inhibiting willingness to tax-finance government projects: skepticism that they really produce the implied economic or cultural return. Thirdly, without the burden of a moral position, many taxpayers simply resent higher and higher tax rates, whether direct or through inflation.

Fiscal spending projects can be financed either by tax revenue or by borrowing. The use of borrowed funds in effect shifts the burden of the national debt to future taxpayers. When tax revenue is insufficient to cover desired expenditures, a budget deficit must be covered by borrowing. This has a direct monetary effect, which is restrictive and raises interest rates, which would be a dampening force on the economy. The argument for fiscal spending, though, is that monetary side-effects are insignificant compared to the direct demand and employment effects of government spending. Of course if government merely spends where the private sector would have spent anyway the only significant result is a "crowding-out effect", as the government's share in the mixed economy increases. At the federal level in Canada, fiscal measures are presumably part of an overall stabilization program — they complement the monetary policy of the day, softening its harsh edges, particularly in the unemployment area during a season when monetary policy is being used to counter high inflation.

The cry for a balanced budget is always strongest when government is perceived as the cause rather than the vanquisher of inflation. When faith in government is strong, counter-cyclical economic policies receive the strongest support. Like a household whose income is unusually low in one particular year, deficit financing — borrowing — to maintain a stable average standard of living or output is a natural and sensible thing for governments to undertake. In years of higher income and economic activity, the tax system draws a higher revenue from the economy, and government spending for stabilization purposes may be reduced significantly. In "boom" times fiscal advice would prescribe a budget surplus, akin to the household that pays off its debts with the income from particularly good years. In this sense, then, there is more or less of a budgetary balance over the business cycle. Of course there is no ordained reason for the business cycle to match the fiscal accounting period. Public accounts are reckoned on a yearly basis; economic cycles may be shorter, but are usually much longer, and always of different lengths, one after the other.

In a society that has developed sophisticated systems and institutions to accommodate almost every exigency of technical and cultural progress we have never seriously considered flexible-length accounting periods to match the cycle relevant to each particular financial operation. This is a truly archaic aspect of our society; a disbelief that the common people will be able to cope with such sophistication. These outlooks are no doubt a remnant from medieval feudal times, when the business cycle was the agrarian cycle of the seasons and accounts were settled on St. Martin's Day, with tithes of corn and barley presented to the lord of the manor. A balanced budget for its own sake is analogous to serfs and vassals being forced to maintain a clear account with their lord at the end of each month. Their income is annual; if they were not permitted to owe their payments, they could never enter production in the first place. Today, with erratic external factors playing so heavily in our economy it is naïve to assume that even annual reports have meaning in any cyclical sense. At best they ensure that there is financial accountability through public disclosures at regular albeit arbitrary intervals.

In our times government is losing the fiscal confidence of much of the electorate. In part this is due to the peculiar nature of the prime economic problem, inflation, which is perceived as an ill that can be fought on an individualistic basis; everyone feels that both with and despite community efforts they can devise a personal strategy to hedge inflation, thus the problem and its effect on the community as a whole are never thoroughly addressed. Unlike a military enemy which causes people to support central leadership for protection, inflation does not pose just a singular threat to the community; it is also a one-to-one fight which many people believe they have a chance of winning — although a "win" over inflation is merely a transfer of the problem to another member or sector of their community.

Furthermore, inefficient government spending fuels inflation, making the problem worse and eroding even more a public trust of strong central economic action. Clearly the Thatcher government in Great Britain has realized this, slashing fiscal spending programs drastically, and putting forth a tough monetary policy against inflation. Where government is slow in reducing spending programs the cry for fiscal reform is amplified, and public opinion ultimately calls for a balanced budget. Deficit financing is unacceptable because people want spending cut. They will not tolerate a budget surplus since in time of recession people would need and demand a rebate of every unspent tax dollar. This is the attitudinal basis of current calls for budget balancing. As long as taxes do not increase, in a period of inflation a balanced budget must mean an effective reduction in government spending, which seems satisfactory in answer to the concerns described above.

The flaw, however, is simply that a balanced budget is not the real issue. Rather, governments must insure that they spend efficiently and effectively. Nothing short of this will improve the situation. And they must do so before public opinion forces a balanced budget or other measures, which may not be ideal under the circumstances.

In the late seventies, deficit financing became a markedly prominent feature of the Canadian public accounts. Alarming as this seems, as a proportion of Gross National Product the debt has not risen significantly over a longer historical series. This, however, should not be ammunition for the deficit-spending camp. Rather, to the extent that fiscal policy can be effective in macroeconomic stabilization, it should be used in a counter-cyclical manner. This notwithstanding, it will be a veritable task to sort out the how and how much of fiscal activity.

In periods of inflation one further issue arises. This is the question of implicit and explicit taxation. Especially topical as the federal government considers discontinuing the indexation of personal income taxes, it is opportune to emphasize now that inflation itself is a tax, which lowers people's real income. Clearly the printing of money has an inflationary effect, effectively transferring purchasing power from the general public to the government, and from other levels of government to the federal level since the transfer is always in the direction of the monetary agent. Additional transfers occur as people are raised through inflation into higher proportional tax brackets. But if income tax is indexed to inflation, at least in tax payments any such transfers would be made explicit through changes in the tax rates themselves. If inflation persists and indexation is removed, tax rates will look the same even though there is an additional transfer of purchasing power away from the taxpayers towards the government. This invisible tax escalation opens the fiscal system to suspicion, and never completely allows full disclosure of what individuals have actually contributed in terms of real income or purchasing power. Fiscal responsibility includes as much the concept of forthright accounting as the notion of thorough project evaluation. Movements away from either of these ideals are bound to inspire cynicism and distrust.

SUGGESTIONS FOR FURTHER READING

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