THE BUDGET CONSTRAINT[1]

By
Ted Evans

In addressing our core subject of 'the budget constraint', I shall attempt to answer three related questions:

- First, what is the budget constraint?
- Secondly, should we be setting aside funds now to cater for expected increased budget demands in the longer-term? And
- Thirdly, do we need to always balance the budget or are there grounds for running deficits?

The Budget Constraint

The lay understanding of the budget constraint would probably read something like 'insufficient funds' or 'the amount of funds available'. In many respects, this is close enough; but economists like to complicate things; and there is, indeed, need for more precision because governments can always 'create' more funds, can't they? They can print money or they can raise more taxes or they can borrow. Yes they can, but not without consequences for things that matter such as growth and inflation – and that's where the constraint arises.

So we should be clear that when we refer to insufficient funds we mean insufficient command over resources. Resources comprise capital and labour and it is typically the resource that is in most inelastic supply that will provide the operative constraint. Hence, in developing economies, capital is typically the operative constraint; while in mature economies such as Australia, labour will typically prove to be the critical constraint.

Hence Australian governments are constrained in their spending by their limited ability to attract labour from alternative uses (including idleness) without either increasing the price of labour or reducing private sector demand and hence growth. At any point in time, the elasticity of the labour supply, and hence the force of the constraint, will be determined by a combination of cyclical factors (the strength of aggregate demand) and structural factors (labour market flexibility, tax/ welfare interaction, etc).

Because of the difficulty of changing those structural factors in the short-term, and of forecasting the cyclical factors at any time, governments around the world are increasingly leaning towards a medium term approach to the budget constraint – adopting fiscal rules rather than fiscal activism in the Keynesian sense. That does *not* mean that the aggregate demand effects of budgets can be ignored; and it does not rule out activism, in either direction, where the circumstances are clear. It simply

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means that communicating the budget constraint by way of easily understood rules is likely to provide more clarity to those who must make the majority of economic decisions, those in the many private sector market places.

The Australian government's current fiscal rule of 'balance, on average, over the cycle' is not the only one that could be used but it is probably the best of the alternatives. While lacking in some definitional precision, it does give clear guidance that the government will not seek to command resources by resort to its balance sheet and it will borrow, in aggregate, only when the state of the economy warrants.

Recent comments by Mark Latham suggest that the Opposition will adopt a similar (perhaps identical) formulation. This bipartisanship on a once controversial topic is one of the many significant Australian achievements of recent years.

Funding future budget requirements – an 'Intergeneration Fund'

Two relatively recent developments have given rise to the suggestion that the government should be putting aside funds now to help pay for reasonably predictable additional spending in the medium to longer term.

One has been the recognition that there are very substantial unfunded superannuation liabilities due to past and present government employees (including parliamentarians) which must be met over the decades ahead. The other has been the acknowledged inevitability of an ageing population, meaning an increased proportion potentially drawing from the budget and less contributing to it.

Hence the idea of an 'Intergeneration Fund' – putting aside taxes now to provide the funds to meet future needs. The idea is soundly enough based in the field of personal finance and it might make some political sense in the field of public finance. But its basis in economics is weak. It may not do much harm but it will detract attention from what must be done.

Let us be clear that the ability of future generations, and their governments, to meet the needs of their day will be entirely dependent upon the size of the economy they command at the time – that is, the size of GDP then or, more precisely, of Gross National Product (GNP).

Hence the greatest contribution that today's population can make to the living standards of future generations is to ensure that today's policies are directed towards maximising future GNP.

One might say indeed that the "intergeneration fund' already exists – it is the future GNP or the needed proportion of that. The difference is that, without a specific fund, that proportion is not currently hypothecated to a particular purpose in the way that such a specific fund would be. Rather, it would be left to governments of the future to decide what the priorities of the population of the day might be. That would seem to me to be all to the good.

- It would seem a little incongruous, for example, for the government in say, 2040, to find that it had ample funds to pay the superannuation pensions of former government employees but a shortage of funds to pay for public

pensions or any of the many high priority spending requirements that will almost certainly arise unforseen.

Hence, not hypothecating some of today's taxes to a particular set of *foreseeable* priorities, at the expense of the unforeseeable, will give future governments greater flexibility and lead to a better public policy outcome in the future.

But, much more importantly, the recognition that the issue is not one of funding but of maximising future GNP should oblige us to address the question of what is the best way of achieving that. It may well be that Australia's future GNP could be maximised by setting aside certain of today's tax revenue in a well-managed intergeneration fund – though I doubt it. More to the point I doubt that the question has even been addressed in these terms.

It may just as well be that future GNP would be maximised by leaving the tax revenue in the hands of its present owners, to invest as they will.

- Or by the government's investing the same amount in public infrastructure, such as education, which might be calculated to yield a higher return than that on even the better private investments.
- Or by government expenditure in areas which might not qualify as infrastructure in the classic sense but which form part of our social infrastructure and which critically affect our future growth rate. I am thinking here, for example, of those elements of our tax and social security systems, such as high effective marginal tax rates, which bear upon workforce participation, a key element in the future growth equation.

On the issue just mentioned, tax/welfare interaction, I have been struck by the several sessions at this conference that have addressed the issue, but by the singular lack of progress in finding a solution. More than one participant has said something along the lines of 'we know the solution but it can't be afforded'. The budget constraint in operation! Yet when one considers the consequence of the interaction problems for such critical issues as labour force participation and productivity, one is inclined to ask 'can we afford *not* to address it.'? To which I would quickly add the question 'would we not be better off (i.e. have higher future GNP) with lower marginal tax rates and higher average tax rates. In short there is an affordable solution.

Hence the basic issue is to better assess our taxing and spending policies to allow us to take better-informed decisions on how to maximise our future growth.

Deficit spending

That conclusion leads us easily into the third issue – should we be hung up on achieving budget balance, or are there not expenditures warranting borrowing and running deficits?

The first part of that is easy. There clearly are public expenditures that yield a high enough return over time to warrant spending more than just the tax revenue that might be 'readily' available i.e. to warrant borrowing. In some cases, such as education, this might be the case at most if not all times. In others, the case may be temporary,

simply because the need for the spending had not been adequately foreseen; defence spending will often take on this characteristic, as will most forms of disaster relief.

There will be other cases where needs have been long ignored, such as in the case of the environment, and early expenditure could yield both environmental and economic benefit.

In all of these cases I don't believe there is merit in having separate current and capital budgets with borrowing being restricted to capital purposes. Although that makes accounting sense, with public goods there are many which are classified as current but which have a genuine capital nature because they typically yield benefits over time: international relations and market regulation are obvious cases in point. Another, very well addressed in the session immediately preceding this, is early childhood intervention programs, where (mainly current) expenditure over the first few years of a child's life can yield substantial economic and social benefits over a lifetime.

The problem with drawing current/capital distinctions, which are largely arbitrary, is that the prioritisation process becomes distorted, typically in favour of pet infrastructure projects.

It is that prioritisation process, necessitated by the budget constraint, that is the core function of government.

In addition, the identification of individual expenditures with sufficiently high returns to warrant borrowing does not, of itself, lead to a conclusion that the *overall* budget should be in deficit or, as the case may be, in larger deficit. That decision must still be made on a consideration of demand management issues (can the economy cope, in the short-term, with a (larger) deficit?). If the answer is no, the Budget constraint holds and the difficult issues of priorities must still be addressed.

The problem with deficits is not that they are bad, *per se*, but that history has shown them to be addictive – and there's the rub.

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