Budget Balance and Sound Finance

By Richard A. Musgrave[1]

Sound finance, as current thinking tells us, calls for a balanced budget, that is for the cash flow of incoming tax receipts to match that of program expenditures. Even better, it is said, a surplus of tax receipts should be shown. Deficits are viewed as inherent evils, and past sins of public indebtedness should be paid off. Such is the advice of central banks, the International Monetary Fund and even entering into the strictures of deficit limits set by the European Union. Moreover, this view also receives current support from the economics profession. Nevertheless, it is poor economics. Whether or not the budget should be balanced in any one year, depends on the policy goals that are to be met and on the economic setting in which the budget operates.

At the same time, sound economics is only part of the answer. Actual policy is shaped by the pressure of fiscal politics and may not meet that standard. Guarding against misguided politics may thus call for restraint to prevent abuse, even at the cost of having to accept second-best solutions. Nevertheless, it is important that the economics of budgetary balance be understood, and we begin with that perspective, leaving fiscal politics for later consideration.

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I Budget Balance and Assigning the Cost of Public Services.

The first and most immediate task of budget policy is the efficient and equitable provision of public services. A second involves its use as an instrument of macro policy and stabilization. Appropriate budget balance differs in these two settings. The former is considered first. For that purpose, we assume the budget to operate in a full employment economy without need for fiscal stabilization. Full employment and price level stability are maintained automatically by the functioning of the private and the public sector and the shares given to consumption and investment.

Capital and Current Expenditures

Whatever the nature of the project to be undertaken, cash must be made available for its finance. It may be obtained either by tax or loan finance, and a rule of fiscal prudence is needed to decide which form is to be used.

That rule (with exceptions to be noted below) calls for the cost of a project to be borne by its beneficiaries and paid for by tax finance when benefits are received. In the case of capital outlays, benefits extend into the future and should thus be paid for over time. This permits consumers to spread their cost, as does the use of mortgages for house finance in the private sector. Moreover, future benefits may be enjoyed by individuals not as yet taxpayers when the outlay is made, individuals who would therefore receive free benefits under initial tax finance. By the same token, projects whose benefits are current should be tax financed. What is sound finance thus depends on the nature of the project, calling for a current budget that is tax- and a capital budget that initial outlays of which are debt-financed.

Prudence, however, not only calls for immediate debt finance when the capital outlay is made. It also calls for tax finance of the resulting debt service, including interest cost as well as debt repayment over the useful life of the asset, both items to be included in the current budget and its tax finance.

Over time, the cost of capital as well as of current projects should thus be paid by taxation and the total or combined budget be balanced; but it does not follow that the total budget should be balanced each fiscal year. Depending on the nature of the programs, prudent finance may call for the overall budget to be in balance, deficit or surplus at any given time. The proper state of balance in any year's total budget will depend on whether borrowing to finance new capital outlays exceeds, equals or falls short of tax revenue needed to service outstanding debt.

It remains to be seen just which projects should be assigned to one or other part of the budget. Outlays on durable goods (e.g. the trucks needed for street cleaning) clearly belong in the capital budget, as do costs incurred in the construction of school buildings and hospitals. The former sustain current benefits and belong to the current budget, but the latter may leave the beneficiaries with lasting gains, and thus justify inclusion in the capital budget and debt finance. Other problems, such as arise in the treatment of military equipment must also be met and difficulties in application remain. They do not, however, override the basic case for distinguishing between rules of balance in the current and capital budgets. Separation of the two budgets is essential to a meaningful appraisal of budgetary balance in any given year.

Emergency needs. The distinction between capital and current outlays may have to be set aside and debt finance of current outlays be called for in periods of emergency needs, caused by natural disasters and in the context of war finance. Expenditure requirements then become unusually high so that limitation to tax finance would impose an untenable burden. Debt finance is then appropriate to spread the cost, especially so where the benefits of a successful outcome are shared in the future.

Hauling In. A further case for debt finance may arise when a poor but developing country wishes to relieve the burden of prevailing poverty by drawing on the benefits of future income growth. It may wish to do so even though this contradicts the rule of fiscal prudence followed above. Such "hauling in" of future benefits may be accomplished by debt finance of current consumption outlays paid for by later tax-financed debt retirement. Given the scarcity of available domestic capital, and to cushion the impact on domestic growth, borrowing abroad enters as the appropriate source of finance.

Surplus Finance

We now turn to situations where beneficiaries build up reserves to pay for later benefits in advance, thus generating an initial surplus.

Retirement Pensions. The appropriate timing of debt and surplus is now reversed as initially saving is set aside to provide for future use. Such is called for when establishing a public system of funded retirement pensions. Future benefits will be received upon retirement, but future beneficiaries are asked to meet the cost in advance with tax contributions during their working years. The system's budget shows an initial surplus. The Treasury uses that surplus to retire publicly held debt, establishes a retirement fund and credits it accordingly. As this process continues, and assuming a constant population, receipts from contributions and interest will come to match payments, the surplus will cease and the system's budget will reach balance.

Establishment of a funded pension system thus involves a sequence from surplus to balance in its budget. As with the opening of a private pension scheme, an initial period of saving and surplus is needed. If included as part of the total budget along with other items, an overall surplus appears, but this is no sign of fiscal virtue. That surplus is committed already to future pension payments and is not available for tax reduction or the finance of new programs. The task of funding becomes more difficult under conditions of an aging population. As now contemplated in the United States, adherence to pay-as-you-go finance becomes untenable and transition to a funded plan has to be undertaken.

Reserve Finance. Similar considerations arise when provision is made for setting aside reserves to meet future emergency needs. Rather than relying on later debt finance and thus passing the burden to the future, that shift may be avoided by taxing in advance. As in the pension case, use of the resulting cash surplus may be postponed by retirement of outstanding debt and be left for subsequent withdrawal. As before, a temporary surplus in the overall cash budget results, but once more is committed to later use.

II Budget Balance and Stabilization Policy.

In the preceding section, the issue of budgetary balance has been viewed in the context of an economy that automatically yields a full employment level of income, so that there is no need for fiscal stabilization. Sound finance then calls for the cost of public services to be met by taxation when the benefits occur. This means that appropriate finance depends on the nature of the particular program. A distinction needs to be drawn between balance in the current and in the capital budget, with balance called for in the former and debt finance in the latter. Such is the case in a self-stabilizing economy that automatically maintains a full employment level of income. A new dimension is added once the assumption of an automatically stabilizing economy is corrected. Fluctuations do occur and sound fiscal policy now acquires the further function of acting as a tool of stabilization. Prudent finance now raises a new set of considerations and calls for new answers.

The Rationale of Imbalance

Given a full employment economy, as we have seen, the sound form of finance depends on the nature of the program, whether its benefits will occur currently or be spread over the future. As we turn to an economy that is subject to fluctuations, that distinction loses its strategic importance. Sound policy no longer aims to match prudence in the private household, but aims to correct a failure in the functioning of the market.

Appropriate balance no longer depends on the benefit span of public projects, but on the budget's impact upon the level of aggregate demand.

That view of fiscal policy emerged with the Keynesian Revolution of the 1930s. Unemployment had reached disastrous levels and job creation had become the dominant policy concern. The Keynesian view of market failure offered an explanation and solution. The fault was seen to rest in a deficient level aggregate demand, and the market's inability to balance saving and investment at a full employment level of income. Moreover, monetary policy and credit ease had been rendered ineffective by an infinitely elastic demand for liquidity. Fiscal policy by way of deficit finance was thus left as the remaining solution.

At first deficit-financed "public works" offered the most immediate means to raise the level of demand, and thereby to move towards full employment. Though of faltering initial success, its potential was proven later by the budgetary and economic expansion of World War II. Subsequently it was seen that fiscal stabilization need not depend on raising demand via increasing public expenditure and in turn the size of the budget. The required level of deficit could also be reached by tax reduction. As was expressed in Abba Lerner's pure model of "functional finance",[2] the level of expenditures would be set so as to meet the need for public services, leaving that of taxation (and hence the state of budget balance) to be set where needed to yield the proper level of aggregate demand.

The logic of this model, however, left open the problem of servicing public debt. Should support be needed for a long time (an assumption of economic stagnation made early on by many Keynesian economists), a continuing increase in public debt would result. Lerner contended that servicing domestically held debt imposes no resource cost, but only a shift between parts of the economy, but this overlooked the rising efficiency costs of taxation. Comfort was taken, however, in noting that GNP would rise along with public debt, leading the debt-to-GNP ratio to level off, and with it the tax rate needed for debt service.

Over time, and with improvement in the performance of western economies, the public works and stagnation oriented view of fiscal policy was relaxed. Attention shifted to changes in the level of tax revenue rather than expenditures. Monetary policy reappeared as an effective policy instrument and concern shifted to preventing inflation rather than raising demand. Instability came to be seen as a cyclical problem, with reliance on built-in changes in the state of budgetary balance. Beginning in the '50s, macro theory shifted from a short to a long run perspective, modeling the state of budget balance in a setting of equilibrium growth.

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[2] See Abba P. Lerner, The Economics of Control, London: Macmillan, 1944, Chap. 4.

These developments brought changing perceptions on just what the role of fiscal policy should be. The functional forms describing consumption, investment and demand for liquidity was no longer found as postulated in the early Keynesian model, although much of its basic rationale remained. Aggregate demand continued to matter, as did the effect of budget balance on its composition and level. While fiscal policy had lost its primary and unique role in stabilizing the economy, its essential rationale had remained intact.

More recently, this has been questioned by those who put stress on rational expectations. On that basis, as it is argued, a shift from tax to loan finance may no longer be expansionary by releasing disposable income available for consumption. Tax finance calls for immediate payment, but loan finance creates an obligation of future tax bills that become payable when the debt is serviced and paid off. The loss, measured in terms of present value is the same in both cases. The rational taxpayer, as was already noted by Ricardo, will thus respond in the same way.[3] Such, however, will be the case only under a set of rather unrealistic assumptions. Actual taxpayer behavior hardly meets the stricture of full rationality. Moreover, taxpayers do not have the information needed to do so. They do not know just how the future tax system will distribute the cost of debt service, and hence what their own share will be. A second consideration further questions the expansionary impact of a shift to deficit finance, now noting restrictive effects on investment that might result. Deficit finance, by increasing public debt will raise long term interest rates. Investors anticipate the tax burden needed to meet future debt service. Investment is retarded and deficit finance may be counterproductive. This reasoning is not without merit, but much depends on investors' confidence.

New views also entered regarding the expansionary effectiveness of various forms of tax reduction. While the Keynesian perspective had pointed to the expansionary demand effects of reducing taxes on consumption and wage income, supply-side considerations pointed to gains in investment generated by reduced taxation of capital income. More generally, increased attention has been given to the efficiency cost of taxation as a factor limiting the appropriate size of the budget and marginal rates of taxation.

In all, much has transpired since the birth of stabilizing fiscal policy in the Great Depression of the '30s, but the state of the budget remains an important part of the policy scene. Such is especially the case in the current setting, when the premise of lasting prosperity (similar to that of stagnation half a century ago) has been replaced once more by the reality of cyclical instability.

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[3] See Robert J. Barro, "Are Government Bonds Net Wealth?", Journal of Political Economy, December 1974.

III Reconciliation

The appropriate state of budget balance as defined in the two preceding sections differed. In the first, the requirement of balance rested on a principle of fiscal prudence. Beneficiaries were to assume the cost of public services by taxation when benefits are received, calling for sustained balance in the current budget, and debt finance of new programs in the capital budget. In the second, focus was on the expenditure total and the budgetary impact on aggregate demand.

In a cyclical setting, capital expenditures and their debt finance may be moved up or postponed, depending on whether the state of demand is deficient or excessive. Thereby, a stabilizing effect can be exerted without distorting the longer run balance between private and public sector resource use. Debt finance of current expenditures might also be used in a counter-cyclical fashion, thereby temporarily suspending the rule of fiscal prudence, without breaking it over the cycle. This may be generated by automatic fluctuations in the tax base and without calling for changes in tax rates. All this was discussed in the 1950s and '60s, then lost sight of, but reemerged in the boom-bust cycle of the U.S. economy during the recent decade.

Reconciliation becomes more difficult when a longer view is taken, especially when there is a sustained need for restrictive or expansionary budgets. Such was the case early on when sustained deficits were thought to be needed to lift a stagnant economy, and it has now reappeared when a sustained surplus in the accounts of the pension system is called for to meet rising claims on future benefit obligations of an aging population. Monetary policy must then be relied on more largely when expansion is needed, but its effectiveness may fall short of what is required. The temptation is to cut back on the rest of the budget, including the provision of essential public services. There is no ready way of resolving the conflict, except perhaps by resort to a system of pay-as-you-go finance, which provides for flexible adjustments in the level of benefit payments made in line with changing levels of the working populations, and per capita income net of payroll tax.[4]

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[4] See R.A. Musgrave, "A Reappraisal of Social Security Financing" in Social Security Financing, edited by F. Skidmore, Cambridge, MA: MIT Press, 1981

IV Fiscal Politics.

Our concern so far has been with how fiscal policy *should* be conducted and how the state of budgetary balance *should* be set. This needs to be understood, but it is not the entire story. The budget is the final outcome of a political process and, in a democratic society, is determined by the interaction of numerous individuals and groups who pursue their particular interests and objectives. That interaction in the end determines the state of budgetary balance, and the state of balance itself becomes a means by which to reach various goals.

A central factor is the impact of budgetary balance on the size of the budget. With current tax finance, the full cost of public services and who pays must be faced at once. Under debt finance, this becomes apparent only over time and – contrary to the rational expectations-based Ricardian view – tends to be overlooked. Proponents of large budgets therefore tend to favor deficit finance, while balanced or surplus budgets are favored by those wishing to restrict the size of the public sector. Similar considerations apply to the use of fiscal stabilization. Ready access to deficit finance may be destabilizing and budget size enters into how stabilization is implemented. Proponents of small budgets favor expansion via tax reduction while those of large budgets favor increased outlays.

A balanced budget rule may thus serve to secure fiscal discipline, especially in the finance of current outlays and to protect the funding of a pension system. At the same time, imposition of a hard and fast balance rule may block essential programs and interfere with stabilization policy when an expansionary budget is needed. Conflicts thus arise when trying to reconcile the various goals of correct budget policy.

Supporters of large and small budgets may do so because they like or dislike particular programs, but that is only part of the problem. Equally important is who pays. In a normative model, as I proposed some time ago, one may think of the budget as divided into three branches, dealing with allocation, distribution and stabilization respectively.[5] In such a system, the provision of public services by the Allocation Branch would be financed in the spirit of benefit taxation, i.e. people would contribute in line with the marginal utility which they derive from the service. Thereby the political process of voting, as first argued by Wicksell, should approximate an efficient choice of resource use and its division between the private and public sectors. Taxation not only provides revenue but also can serve to reveal voter preferences.[6] Adjustments in the state of distribution,

[5] R. A. Musgrave, The Theory of Public Finance, New York: McGraw-Hill, 1958.
[6] See R.A. Musgrave and A. Peacock (eds.), Classics in the Theory of Public Finance, London: Macmillan, 1958, pp.72-118.

provided for by the Distribution Branch would be implemented via a tax-transfer system and would thus be independent of the service level and burden distribution in the Allocation Branch.

This division of functions, though useful from a normative perspective, is not matched by real world practice. Here distributional concerns are mixed in with the finance of public services rather than set aside and dealt with as a separate issue. Voters who stand to be affected adversely thereby have an additional reason to favor budgetary restraint, while those expecting to gain will oppose it. The outcome thus depends on how taxes are imposed. Considerations bearing on the economic impact of various forms of taxation also bear on what the burden distribution will be, with the debate over tax structure a major determinant of budget size and balance.

Once more conflicting considerations enter. On the one hand, a realistic view of fiscal politics tends to support the case for institutionalizing budgetary discipline by limiting the permissible range of deficit finance, especially so for lower level governments such as the states in the U.S., where stabilization policy, both fiscal and monetary, is appropriately vested at the central and federal level. With the economies of the various states integrated by the high degree of resource mobility, reliance may generally be placed on centrally directed fiscal policy. This differs from the E.U. setting where a uniform deficit limitation in relation to GDP is imposed on member states, states with economies that are not closely integrated and may therefore need access to their own individual stabilization policies. Appropriate stabilization policies may also differ with the state of economic development and prevailing levels of income. The social burden of fiscal restriction may prove more severe in poor countries, calling for stronger reliance on other approaches, including limitation of imbalance created by short term capital flows.

Investigation into the proper state of budget balance, unhappily, does not offer a simple conclusion. A principle of fiscal prudence calls for differential treatment of current and capital outlays into separate parts of the budget. A rationale for stabilization policy calls for the overall state of balance so as to secure the needed level of aggregate demand. Both perspectives have their logic but may require different policies and compromise. Moreover, fiscal politics enters and may conflict with sound policy. Difficulties do indeed arise, but they are not met by equating “soundness” with a “balanced budget”.