Market economy needs to run budgetary deficits*

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First of all, I would like to reflect on the role of economic theory in developing the strategy of economic growth, using the example of fiscal policy. Michał Kalecki once said that there was nothing more practical than a good economic theory. I would like to go a step further and say that there is nothing more impractical or even harmful than a bad economic theory. This applies in particular to the currently prevailing views on public finance.

Constant grumbling about budget deficit and demands of government expenditure and revenues being balanced are commonplace; they are present also in the papers prepared for this Congress. Yet, the matter is not so evident, although by appealing to the individual experience it easily gains public approval. Indeed, private economic entities should run up debts in special cases only; because they also have to repay the debt. Yet, macroeconomic relationships are not identical to those at household or company level. For example, the generally accepted thesis is that the government budget plays the role of a stabilizer of cyclic fluctuations in private investment. Namely, when investment grows rapidly during a period of economic boom, the government revenues grow as well. As a result, the government deficit declines and curbs GDP growth. On the other hand, when investment declines during a slump, budget revenue declines as well. As a result, the government deficit grows and restrains the GDP decline. Changes in the government deficit thus reduce the amplitude of economic fluctuations. Yet, this mechanism is operative only when the Minister of Finance behaves unlike the private investor. He does not increase expenditure when the budget revenue grows and does not reduce expenditure, or even increases it, when the revenue falls in order to keep good economic climate and maintain the level of employment.

Given the existence of business cycles, demanding the maintenance of a balanced budget is an obvious mistake. A permanently balanced budget cannot contribute to the stabilization of economic fluctuations. But – it is often argued – the deficits incurred during slumps should be matched by budgetary surpluses earned during booms so that over the cycle the average deficit should be about zero.

However, running deficits is a long-run regularity rather than the exception.

Let us have a look at statistics. Over the past few decades in all major countries of the EU-15 (as well as in the United States and in Poland) a budget deficit was the rule rather than the exception. This is documented by Table 1.

Table 1

Frequency of budget deficits D (general government expenditure less general government revenues) in major EU countries, years

Country and period	D > 0	0 ≥ D	Average D/GDP
Germany (1970-2007)	31	6	2.1%
UK (1970-2007)	30	7	2.8%
France (1978-2007)	30	0	2.9%
Italy (1976-2007)	32	0	7.4%

Source: European Commission, Directorate General ECFIN, Economic and Financial Affairs, Statistical Annex of European Economy, Spring 2007.

For the major EU countries for which harmonized long-time series are available, a budget deficit was recorded every year in France and Italy, and 31 and 30 times respectively over a period of 37 years in Germany and the UK. The arithmetic mean of the budget deficit/GDP ratio ranged from 2.1 to 2.9%, with the exception of Italy. For smaller EU-15 countries for which statistical data are available the

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findings are similar. The Netherlands is an exception: here, in 19 years – out of the 38 years under analysis – the budget was balanced or showed a surplus, and in 18 years it showed a deficit. Yet, also in this country the arithmetic mean of the budget deficit/GDP ratio for the whole period was 2.4%. In the years 1961-2007 the United States posted a budget surplus 4 times only and ran a budget deficit as many as 43 times; the average budget deficit for the whole period reached 2.6% of GDP. For Poland, data from the same source are available for the years 1995-2007 only. In all those years with no exception Poland ran a budget deficit and the average budget deficit for the whole period amounted to 4.4% of GDP.

Should the budget play the role of a stabilizer of economic fluctuations only, the presented data would suggest that finance ministers took reckless decisions for whole decades regardless of the fact that governments changed from leftist orientation to rightist and vice versa. Since this conclusion is difficult to accept, it is necessary to consider whether there may be other reasons for regular budget deficits. In our view there are such reasons both in public finance and in the national economy as a whole.

Every generation enjoys the benefits of public infrastructure which has been created following public investment carried out in the past, and invests in public infrastructure (and human capital) to be left to serve future generations. A constant public debt to GDP ratio could be considered an acceptable and fair intergenerational compromise. Thus, if nominal GDP grows over a given time on average by a certain percentage annually, then the nominal public debt should grow by the same percentage. This condition will be fulfilled if the budget deficit constitutes on average a fixed part of GDP. So much as regards a budget deficit justified by public investment needs.

Yet, a budget deficit would be necessary even without public investment. The private sector's propensity to save measured by the ratio of private saving to GDP (hereinafter 'saving rate') is not constant in individual countries, yet shows relatively minor fluctuations. In the periods considered the average saving rate in Germany amounted to 21.1 (coefficient of variation 4.8%), in the UK to 16.7 (coefficient of variation 10.2%), in France and in Italy to 18.5 (coefficient of variation 8.3%) and 24.7 (coefficient of variation 14.6%) respectively. In the United States the average saving rate reached 17.8% (coefficient of variation 10.2%) and in Poland 18.8 (coefficient of variation 5.2%). Assuming a relatively constant saving rate in particular countries the level of GDP in every year depends basically on the level of private investment. The higher the private investment, the higher GDP, the higher the employment level and the closer we are to full employment. Over the past few decades, especially the EU has experienced a relatively high unemployment rate. It is determined primarily by insufficiently dynamic private investment. The generally higher private propensity to save than the private propensity to invest is a characteristic feature of the capitalist economy. In these conditions, a budget deficit provides the private sector with the opportunity of additional sales – and additional employment – above the level determined by the level of private investment. Without a budget deficit – and an export surplus – the efforts of the private sector to achieve the desired level of saving would not succeed and would lead to a decline in GDP and employment down to the level determined by the volume of private investment. This is the core economic principle of the budget deficit being a more or less regular phenomenon in a dynamic capitalist economy.

The private sector taken as a whole saves more than it invests. In other words, its financial balance, defined as the difference between revenues and expenditure, is generally positive. In the analysed periods it amounted to 3.4% of the GDP in Germany, to 1.2% in the UK, to 2.2% in France, to 7.1% in Italy, to 1.3% in the USA and to 1.6% in Poland. This gap (the current account of the balance of payments set aside) was closed by budget deficits as presented in Table 1.

It should be pointed out that the financial balance of the private sector consists of the financial balance of businesses and households. The financial balance of businesses is generally negative, the financial balance of households is generally positive; thus, businesses generally run up debts with households. Yet, in normal conditions the savings of households exceed the debt of businesses and thus the resulting surplus of the private sector may be realized (abstracting from foreign trade and investment) only through a rise in government debt. In certain countries the private sector happens to post a negative financial balance; yet, this is an untypical situation accompanied by rising foreign debt. Since the beginning of the 1990s the United States has been a flagrant example of this situation. Rising foreign debt of the United States is accompanied by a low saving rate of households, sometimes by rising household debt. This would not be possible outside the US and even there this situation cannot persist indefinitely since the growing debt of households undermines their ability to repay or even service the debt and thus their creditworthiness.

What has been said above does not mean that a budget deficit does not have its negative effects. Indeed, public debt service (as any public good financed with taxes) is a burden for all households, and public debt service benefits mainly households holding government bonds. Another problem is the rate of interest on public debt. If this rate is higher than the growth rate of nominal GDP, then a rising share of the GDP will be accruing – in the long run – to the wealthy holders of the public debt via interest payments. But a rising income share of wealthy households does not increase effective demand for consumer goods sufficiently to compensate for the taxes (levied also on low-income households) out of which interest payments are made. One of the objectives of economic policy should be to prevent a situation in which the interest rate exceeds the growth rate of nominal GDP.

At this point it should be emphasized that the current EU fiscal framework ignores the whole problem completely. The Stability and Growth Pact '*… lays down the obligation for Member States to adhere to the medium-term objective for their budgetary positions of "close to balance or in surplus" (CTBOIS) …*'.[1] This, of course, is in direct conflict with the fact that the EU private sector taken as a whole shows a positive financial balance amounting on average to 1.9% of GDP. Moreover, the European Union taken as a whole has a basically balanced foreign trade. This suggests that the average budget deficit of the European Union taken as a whole, considering the private sector's existing propensity to save and to invest, should be equal to approximately 1.9% of GDP of the EU; any attempt to reduce the average budget deficit below that figure is bound to unleash deflationary and contractionary trends in the EU economy (as it has already done in Germany).

The limited time I have been given to deliver this speech makes it impossible to address two issues which seem important in the light of the material presented to the Congress. The first issue is that we should not exaggerate the role of information technology and should look with caution at the new era it is bound to open. The second issue is the type of the recommendable development strategy. As far as the first issue is concerned, I just want to mention that we still wear IT-free underwear, we still eat IT-free food and live in IT-free houses. Traditional goods and services continue to account for the majority of demand. I am addressing this problem since in a country like Poland which is not among the leaders in the world technological advancement we can still achieve a lot by making use of the existing technological solutions. This is one of the privileges of countries which lag behind and which can benefit, almost free of charge, from the existing solutions. Certainly, we should engage in training, increase the currently extremely small outlays on scientific research, but we should not, at the same time, forget about the use that can be made of the existing inventions. I am not against

[1] Council Regulation No. 1055/2005 amending the Growth and Stability Pact. *Official Journal of the European Union*, 7 July 2005, L. 174/1.

seeking new ways but in this situation the government has a very important role to play – namely, to set certain priorities in development. Admittedly, this is risky: you can always make mistakes while selecting priorities. On the other hand, engaging in a large number of poorly funded research and development projects is certainly not a good alternative. Such an approach is unlikely to yield any genuine benefits.

The second issue is the 'Washington consensus' development strategy based on a few simple principles: the government's role in the economy should be limited to a minimum, thus the requirement of privatization; the government budget should be balanced and the central bank should be primarily concerned with the risk of inflation, thus the requirement of stabilization; finally, the unconstrained market mechanism best coordinates the economy including the labour market, thus the requirement of liberalization. The three requirements of privatization, stabilization and liberalization were and still are the core of much of the orthodox theory – and actually behind the economic policy in Poland. But, is it possible that the same formula proves effective for every country although each country has its own particular characteristics and bottlenecks limiting its development opportunities? Indeed, there are specific conditions in each country. In Poland we have to do with the underdeveloped eastern provinces; there is a large percentage of farming population, in particular people coming from the former state-owned farms; there are problems of small towns and provincial areas; there is a certain demographic structure of the population which used to be very favourable in the past and now has become much less favourable; and finally there is a certain level of social expectations such as free access to schooling, health services and even an acceptable degree of differences in the level of income and earnings. These conditions and expectations cannot be ignored while addressing the long-term strategy of economic growth. Such a strategy should be developed by people who are knowledgeable about those facts. The slogans of stabilization, privatization and liberalization cannot replace the hard work.

Answers to questions:

It has been pointed out that the excess of savings over investment in the private sector may occur with a different level of saving rates and investment rates. This is indeed so. Also, the view has been expressed that in the Polish conditions the rates of private saving and private investment are too low and should be increased. I find it hard to agree with this opinion. Only in a full employment economy the acceleration of economic growth requires a higher investment rate. In an economy with less than full employment such as the Polish economy – and generally in every capitalist economy – an acceleration of growth requires an acceleration of private investment but not an increase in the rate of private saving. I would go further and say that the more stable the rate of private saving, the stronger the impact of acceleration of private investment growth on GDP growth. If, for example, private investment grows by 5%, then assuming a fixed rate of private saving – the state budget and foreign trade set aside – GDP will also grow by 5%. If, however, at the same time the GDP share of private saving grows by 1%, GDP will grow by 4% only. This is the essence of the economic rationality of parallel growth of real wages and labour productivity as this generally favours the stability of the private saving rate. By contrast, the call for real wage growth to lag behind labour productivity growth in order to increase the rate of private saving in fact curbs the growth. Indeed, assuming a certain acceleration in private investment growth, the acceleration in GDP growth will be higher when wages grow *pari passu* with labour productivity than when they are lagging behind.

It is generally believed that there is a simple relationship between the investment rate (i.e. the share of investment in the GDP) and economic growth. There is no such relationship. Already in 1999, William Easterly of the World Bank examined the hypothesis of the alleged '… fixed linear relationship between growth and investment …'.

Studies based on data from a large number of countries do not confirm that hypothesis.[2]

The average rate of private investment in the EU-15 amounts to 19.3%. Definitely, there are certain differences; some countries have a higher rate while others have a lower one. In Poland, the average rate of private investment reaches approximately 25% and thus is relatively high. What Poland needs is – I want to reiterate – rapid investment growth rather than growth in the investment rate.

Here I wish to comment on another statement to the effect that countries with higher budget deficits have, in consequence, a lower rate of private investment. I have no knowledge of such data. If one has access to such data they should necessarily be published, although I doubt they can be found.

One question was raised which was addressed directly to me: what choices should Poland make as far as the direction of scientific research and strategic economic objectives are concerned? This question cannot be answered by a person who left Poland nearly 40 years ago and is just visiting the country for a few days. Every single country needs a specific, tailored strategy, every single illness needs specific treatment; it is not reasonable to apply the same prescription to all countries.

[2] See William Easterly (1999), 'The Ghost of Financing Gap. Testing the Growth Model Used in the International Financial Institutions', *Journal of Development Economics*, Vol. 60, No. 2, December, pp. 423-438.