What is Responsible Fiscal Policy?

By Pavlina R. Tcherneva  Apr 15, 2010, 1:19 PM  Author’s Website

I can’t fault the taxpayer for being upset with the deficit. I blame my profession, which has been spewing nonsense about government spending for decades. Economics is long-overdue for a renaissance. The deficit phobia, not the deficit itself, should be made public enemy #1. Taxpayers are decidedly working against their own interests when they demand that the government reduce or eliminate its deficit. Here is why:

*Government deficits create non-government surpluses.* It is a simple mathematical proposition; it is neither high theory, nor rocket science. If one sector spends more than it earns, another, by the rules of double-entry bookkeeping, earns more than it spends. And so it is with the government—if it spends more than it collects in taxes, it runs a deficit, which is exactly equal to the surplus accumulated by the non-government sector. Deficits create income and profits for the private sector in excess of the taxes the private sector pays to the government. My fellow bloggers have explained this clearly many times before (e.g. [here](#), [here](#) and [here](#)). What I’d like to impress upon the taxpayers is a simple logical flaw in their anger with the deficit itself.

If we want the government to “correct” its budget stance, then we must necessarily be offering to reverse ours. If we demand that the government run a surplus, then we are demanding that we, the private sector, run a deficit. If we are demanding that the government pay off its entire debt, then we must be demanding that every single private portfolio, retirement account, or college fund sacrifice its Treasury securities. Surely the private sector does not want that. The government’s deficit is someone else’s surplus and the government’s debt is someone else’s asset. If you would like to wipe out one, then you must be offering to wipe out the other.

Recall the Clinton surpluses. What was then considered to be a very ‘prudent’ government stance was in fact only possible because the private sector acted ‘imprudently’ and ran negative savings for many years. So, take your pick: would you like the private sector be in surplus or the government? You cannot have both. Presumably, we’d prefer the private sector to save and accumulate financial assets, which means that the government must run a deficit and accumulate financial liabilities (note again, that the [foreign sector balance](#) does not change this story). Because most people do not think about this basic accounting result, they tend to think that a responsible government is one that acts like a household, without recognizing that a ‘responsible’ government is possible only with an ‘irresponsible’ private sector behavior and vice versa. As Rob Parenteau has [argued](#) previously, the quest for fiscal sustainability may very well destabilize the private sector.

Since all of us agree that it is prudent for the private sector to accumulate savings, we must be in agreement that the prudent thing for the government to do is to allow us to be prudent by
running deficits. In other words, a truly prudent government is one that does not mimic the behavior of the private sector, but one that offsets it.*

Even after people grasp this very basic logic, they still get hung up on the question “how long can the government keep running deficits and what if it goes bankrupt?” Here, too, we have to remember that government deficits are unlike those of the private sector. This is because the private sector cannot pay by issuing its own currency or create reserves at the stroke of a pen, but the federal government can. By constitutional right, it has monopoly powers over its currency and bank reserves and, therefore, always pays by creating such reserves when it credits the private bank accounts of its payees (see how the Fed and Treasury interact to make payments). The US government has a Central Bank that never bounces government checks and always makes good on government commitments.

In other words, there are no technical reasons why a nation with sovereign control over its currency, like the U.S., should ever go bankrupt—unless of course a misguided Congress places arbitrary political restrictions on the government to meet its financial obligations.

But just because government deficits can always be financed and just because government deficits create private sector surpluses, does it mean that all kinds of government spending are equally responsible? And the answer is clearly, NO.

A responsible government spending policy is not measured by some arbitrary accounting result called the deficit, but by the impact it has had on the real economy. This same sentiment has been echoed by others. (see here and here).

Different fiscal policies will have different effects on output, employment and inflation. It is on the basis of these effects that fiscal policy should be judged. Those of us, who have gone to great lengths to explain how such a modern money system works, have never advocated ‘printing money’ or deficit spending in unlimited amounts for anything and everything. I have argued elsewhere that a responsible government policy is not one that waits for months and years for the economy to recover to see job growth, but acts immediately and directly to create jobs without delay. In the latter case, spending is intimately linked to actual production and employment. The absence of direct job creation programs indicates a government that has not taken its responsibility to the unemployed seriously. Surely, unemployment insurance helps, but unemployed men and women want jobs, not the dole. Paying a pittance to the unemployed (who are not producing) is not the same thing as paying a living wage to those producing something of value.

If government deficit spending fills the coffers of the non-government sector with net financial assets, then a responsible government does so for all private sub-sectors in need, and links its deficit spending to actual employment and production. So while the government could not sit idly by and watch the global financial system collapse, a responsible policy would have
immediately provided relief for households, small business owners, and states, all of whom have received inadequate assistance in comparison with the financial sector.

So while it is true that government deficits create non-government surpluses, the real question that taxpayers should be asking is, not how large the deficit is, but who benefits from the deficit and whose coffers does it fill?

If the deficit went to bailing out banks, then we know exactly who accumulated net financial assets. If we knew that the deficit saved state programs and prevented school shut downs, teacher layoffs and civil servant furloughs, then we would know that it is they who ‘received’ the deficit. If the deficit went towards massive infrastructure investment and direct job creation, we would know exactly which individuals and which firms got the funds and how many jobs and projects were created.

The taxpayers should not be angry with the deficit itself, but they are right to ask the question which sector is earning and accumulating net financial assets as a result of the government’s deficit spending. And with unemployment still close to 10 percent, personal bankruptcies and foreclosures unacceptably high, broken state budgets and disappearing public programs, and Wall Street bonuses sky high, I think the answer is quite clear.

Wall Street knows all too well that the government cannot go bankrupt, which is why it never objects when the government socializes its losses. Notice how financial gurus temporarily suspend their own deficit phobia until Wall Street’s balance sheets and incomes are restored. The average person, however, does not know that deficits are forever sustainable and that the government is not obligated to raise anyone’s taxes to ‘pay’ for them (see here a discussion on the role of taxes). And so the taxpayer does not demand from its government what the taxpayer genuinely wants and needs: more jobs, more infrastructure, better education, higher quality public services, and a standard of living that only a resource-rich nation as the U.S. can provide. It is time to stop buying into the deficit phobia and demand that the government deficit spend … responsibly.

*I thank Jan Kregel for putting it so succinctly

http://wallstreetpit.com/23332-what-is-responsible-fiscal-policy/