Permanent fiscal deficits are desirable for the high income countries: a note[1]

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1. Budget deficits are a natural consequence of excess private savings

Despite the austerity efforts of fiscal authorities around the world, public financial balances almost always and everywhere end up in deficits. This is no accident: the fundamental macroeconomic identity states that the private sector's excess saving equals the net external lending plus the financial deficit of the public sector. Given the private sectors' preference for running positive excess savings (and the relative unimportance of external imbalances, at least in the longer run) the public sectors are likely to display fiscal deficits secularly.

The public financial deficit and private excess saving are two sides of the same coin. Abstracting from the external imbalances, the public sector financial deficit represents the net (i.e. not covered by taxes levied on the private sector) value of goods and services *acquired* by the public sector from the private sector. Thereby, the private sector earns additional *income* (equal to the net value of goods and services sold to the government). That additional private sector income is neither consumed nor invested. Thus, it constitutes the excess private saving.

The positive private excess saving emerges only because the private sector desires to hold such a debt (e.g. taking the form of stocks of government-issued fiat money). In a closed economy the *consolidated* net financial wealth of the private sector *must* consist, exclusively, of government debt. In such an economy, public debt *is* the financial wealth of the private sector, consolidated. The private sector would not supply the government with goods and services in exchange for the government debt (starting with the government-issued currency) should that debt be considered worthless.

The conventional wisdom underlying the fiscal policies in most high-income countries stresses the need to restrict public-sector financial deficits. This is particularly the case with the European Union. The EU Growth and Stability 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".[2] The Fiscal Compact agreed upon by the majority of EU leaders is designed to strengthen "fiscal discipline" across the Euro area (and beyond). It also imposes the obligation to reduce public sector debt/GDP ratios. Given the sluggish pace of nominal GDP growth, that requirement actually imposes the obligation to run budgetary *surpluses*. Thus the taxation of the private sector (net of transfers to the same) should be persistently higher than the income earned by the private sector on sales of goods and services to the public sector. The private sector would then have to "bleed" for many years to come – for the sake of "sound public finances". (The "sound public finances" are deemed however indispensable for the long-term dynamism of the private sector itself).

[1] This note summarises the argument developed in the author's article "The private saving glut and the developed countries' government financial balance" (*Review of Keynesian Economics*, no. 1, 2019).
[2] See Council Regulation No. 1055/2005 amending the Growth and Stability Pact (EU 2005). The same requirement features in the more recent (2012) Fiscal Compact (Article 3, point 1(a)).

The active policy aiming at balanced public finances implies that the private sector's excess saving is not allowed to materialise (e.g. being "pre-emptively" taxed away). But this outcome is hard to achieve: the private sector is unlikely to completely part with an excess of saving over investment. In rather extreme cases the excess savings would all assume the form of reserves of government-issued cash – thus remaining positive after all. Of course, it is rather unreasonable to expect that under a confiscatory fiscal policy seeking to wipe out the potential excess private saving, the private sector would be induced to increase its investment (or even consumption) spending. In effect, a fiscal policy seeking active consolidation of public finances is doomed to fail. The fiscal deficit will not be eliminated even if the economy is forced into stagnation (or recession).

Conversely, the public sector's financial consolidation can be achieved quite automatically and painlessly whenever the private sector is inclined to expand its investment and/or consumption (thus also reducing excess saving) – as was commonly observed throughout the high-income countries over a couple of years prior to 2000 and (to a lesser extent) prior to 2007.

Admittedly, the developments culminating in the years 2000 and 2007 were "unsustainable". Much of the private investment went into risky (or speculative) activities (e.g. residential construction) that failed to pay off, leaving large segments of the private sector deeply indebted to other private sector segments. Similarly, the expanding private consumption was disproportionately driven by debt owed to other parts of the private sector (rather than being backed by rising wages and other regular household incomes). The *internal* private-sector debt/credit excesses were followed by the painful private sector "deleveraging" (or "balance-sheet recessions") characterised by depressed private investment, increased private saving (depressed consumption out of the disposable income) and – consequently – increased excess saving of the private sector (the latter equal to the increased public sector financial deficits) reaching its (local) peaks in 2003 and 2010.

2. Fiscal surpluses and "beggar-thy-neighbour" policies

It is worth noticing the fact that some OECD countries (Germany in the first place) have for quite some time run fiscal surpluses, not deficits. However, the fiscal surpluses of those countries appear to have been smaller in absolute numbers (usually by far) than the fiscal deficits of others. Also, the fiscal-surplus countries tend to run external surpluses *larger* than their excess private savings. Their external surpluses – essentially equal to the external *deficits* of the partner countries – contribute to the fiscal deficits in the latter. Fiscal deficits disappearing in some (growing) countries do not vanish without trace. Private excess saving in such countries must all come from a rising surplus against foreign countries. They must be reflected (even if not one-for-one) in *higher* fiscal deficits of the foreign countries.

Even if it were in the best long-term interest of the population majorities in each and all of the high-income countries to avoid large and persistent external imbalances (and rely instead on large and persistent fiscal deficits), it is only realistic to expect that in some countries the authorities will choose to behave opportunistically, resorting to beggar-thy-neighbour tactics. However, the reliance on external surpluses substituting domestic fiscal deficits cannot work globally (or for the developed countries collectively) or indefinitely. Sooner or later, growth led by high export surpluses must come to an end either on account of excessively high foreign debt accumulated by the net-importer countries and/or on account of the recurring

protectionist sentiments in the net importing countries. US President Trump's ideas about international trade do not come from nowhere. In either case the policy of basing domestic growth on the beggar-thy-neighbour tactics must end at some point – at least for sufficiently large countries. This policy may work indefinitely for Luxembourg, but not for Germany.
It seems legitimate to assume that in the longer run the (larger) high-income countries individually (and thus also collectively) will not be in a position to "export" their excess private savings in sufficient quantities. In the last instance, the excess private savings can only be absorbed by (and emerge with) properly accommodative and cooperative fiscal policies across a sufficiently large number of high-income countries.

For about 50 years the US public sector has had the privilege of being the principal "absorber" of private excess savings globally. Of course, the *global* private excess saving could materialise because the US has been running external deficits – thus supplying the external surplus countries with additional incomes (in the form of additional dollar balances representing the US *public debt*). The fact that the US dollar has been *the* prime reserve currency certainly makes the sustained US external deficits fairly easy to "finance". Under more balanced international trade other high-income countries could be expected to share the responsibility for absorbing (and generating) private excess savings by running properly accommodative fiscal policies themselves.

3. Private excess savings likely to increase in the future

Whether or not there will be a genuine reason to run such accommodative fiscal policies in the future depends on the tendencies with respect to private saving and private investment. As already suggested there are pretty good grounds to expect a continuation of the past tendencies: a further fall in the investment shares concomitant with the saving propensity rising (or stagnating at best).

The deep ("systemic") tendencies underlying the behaviour of private sector saving and investment are likely to strengthen in the future. In the high-income countries, it is difficult to envision either a decisive rise in the wage share or a decline in income inequality. If anything, the combined effects of progressing globalisation (outsourcing production to low-wage and low-tax countries) and technological change (expansion of "intelligent machines" which will reduce demand for human labour, including high-skill occupations) are likely to support falling investment shares and rising income inequality that increases saving rates. Excess private saving will then increase in tandem with increased income inequality.

Whether such private excess saving materialises will depend on the course taken by the fiscal policies in the high-income countries. With fiscal policies consistently hostile to deficit spending, the private sector would be unable to work out saving in excess of investment. In other words, the private sector's disposable income would not be allowed to rise. In effect, the falling (or stagnant) private saving would be driven to a level consistent with the falling (or stagnant) investment. Under such conditions the real output would remain stagnant, at best.

Alternatively, accommodative fiscal policies would support the private sectors excess savings via matching public financial deficits. The additional demand for private output (equal additional private sector income and equal private excess saving) would support real output growth. Growth driven by rising public debts might continue – as long as the private sectors remained desirous of newly issued public debts. Should, at some stage, the private sectors

become "satisfied" with the quantity of its financial wealth (in the form of public debts held) they might become unresponsive to the public demand for more privately-produced goods and services. At such a stage, deficit-spending fiscal policies would no longer be effective (and the fiscal balance would be automatically restored).

Should one be concerned with a prospect of the private sectors in the high-income countries being finally satiated with their financial wealth? That outcome is rather hard to imagine, and the empirical evidence (the experience of Japan) suggests there is still a long way to go.

In conclusion, should the past (and current) tendencies underlying private sectors' saving and investment continue, one must expect the emergence of large potential private excess saving across the high-income part of the global economy. If the fiscal policies attempt to prevent the materialisation of public sector deficits, real economic growth will likely come to a halt. In other words, continuing output growth of the high-income countries requires cooperative fiscal policies that support the private sectors with income injections financed by rising public debts. This conclusion is a version of the "classical" functional finance principle. However, in contrast to the latter, our conclusion is that public debt must grow more or less permanently – and not only in response to "cyclical" growth slowdowns or occasional recessions. Additionally, whereas the functional finance principle applied in any single country is likely to be impractical (on account of the complications posed by external trade, capital movements and exchange rates), internationally cooperative and accommodative fiscal policies precluding major external imbalances are likely to fare better in practice. Clearly, even if run cooperatively, large functional finance deficits would not be free of potential problems (and thus managing to mitigate the scale of external imbalances). Consideration of those problems goes beyond the scope of this note. In any case, it is worth remembering that if large fiscal deficits become problematic (e.g. when either the private sectors no longer consider the public debt or currency worthy of accumulation or when the mistaken views on the dangers of growing public debt prevail), growth will likely come to a standstill.

Fiscal deficits serving as permanent substitutes for dwindling (for whatever reason) private investment and stagnant private consumption can support continuing overall growth. However, the nature of the economy will undergo gradual evolution. While production (and profits) would remain private, the public sector would become an increasingly important "customer" of the private sector. The public sector would be commissioning from the latter growing supplies of goods and services (to be paid for with public debt). That offers an opportunity for meeting important social goals (e.g. with regard to environmental protection) which the private profit-oriented sector is not inclined to consider on its own.

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