SCHOOLS BRIEF

The public purse

This brief in our series on the modern classics of economics looks at budget deficits. Mr Robert Barro’s paper, one of the most influential of the past 20 years, argued that fiscal policy is impotent.


The impact of government borrowing on economic activity has been a controversial issue in macroeconomics since the days of Adam Smith. Classical economists were almost unanimous in condemning public debt; they believed that a balanced budget was a sign of good housekeeping. Then along came Maynard Keynes, who argued that budget deficits could be used to inject extra purchasing power into the economy and so boost output and jobs.

This view formed the economic consensus until the 1970s. But the emergence of persistently large budget deficits in industrial economies during the past two decades (see chart) has provoked renewed interest in the theory behind fiscal policy. Indeed, to some extent matters have come full circle. Balanced budgets are back in vogue—at least in theory, if not in practice.

Today many Keynesians as well as fiscal conservatives accept that large budget deficits may be imprudent. One reason is that governments may be tempted to finance deficits by printing money, thereby fuelling inflation. Another is that investment may be crowded out as government borrowing pushes up interest rates. Most economists, however, believe the crowding-out is only partial, so increases in budget deficits will expand demand in the economy.

Enter Mr Robert Barro, now at Harvard University but in 1974 at the University of Chicago, armed with his celebrated paper, “Are government bonds net wealth?” His argument, much in keeping with the New Classical approach to macroeconomics, was that the case for public borrowing is flawed—not because borrowing is imprudent, but, far more controversially, because changes in the size of the budget deficit do not affect economic activity. It makes no difference, he argued, whether government spending was financed by borrowing (ie, by selling bonds) or by raising taxes.

Mr Barro had revived an idea first mooted in 1821 by David Ricardo, a nineteenth-century English economist—although Mr Barro failed to give him any credit in his paper. Today Ricardo’s theory (that tax- and bond-financed are equivalent) is known to economists as the Ricardian equivalence theorem. Ricardo raised the idea as a theoretical possibility, then rejected it as practically, he argued, whether government spending was financed by borrowing (ie, by selling bonds) or by raising taxes.

No free lunch

The main flaw, as Mr Barro pointed out, is that this view ignores future tax liabilities. When the government sells bonds to finance a tax cut, a sensible man will realise that at some time in the future he will face higher taxes to cover the interest payments and eventually to repay the debt. Government borrowing only postpones taxes.
Fitting the theory to the facts

Efforts to prove or disprove Mr Barro’s equivalence theorem have generated almost as much controversy as the idea itself. The empirical research remains inconclusive, mainly because it is difficult to distinguish the effects of changes in government debt from other influences.

Perhaps the most damning evidence against Mr Barro in the 1980s comes from America’s so-called twin deficits. A country’s current-account deficit is, by definition, the gap between domestic savings and investment. From this it follows that if private savings and investment remain unchanged, then a rise in the budget deficit (government dissaving) will lead to an increase in the current-account deficit. This is exactly what happened in America in the first half of the 1980s. If Ricardian equivalence had been true, America’s private savings should have risen to offset government borrowing. Instead they fell. Defeat for Mr Barro! Not necessarily. The so-called neo-Ricardians say that private savings were reduced by other factors, such as lower inflation; it was just a coincidence that the budget and the current-account balances moved into the red together.

Mr Barro can point to impressive evidence of his own. Many studies have found no correlation between interest rates and budget deficits, as his theory would suggest. Better still, in the 1980s private savings often moved to offset a change in the government’s budget deficit. In Britain, Sweden, Australia and Denmark budgets moved from deficit into surplus, but this rise in government savings was more than offset by a fall in private savings (see chart).

One of the most interesting studies is by Mr Giuseppe Nicoletti at the OECD.

He examined budget deficits and private savings in eight economies between 1961 and 1985. His numbers rejected the Barro theory for Japan, West Germany, France and Britain, but found a weak link between budget deficits and private savings in America and Canada, and a strong link in Italy and Belgium. Interestingly, Italy and Belgium have the most profligate governments; America and Canada have what many economists consider “unsustainable” budgetary positions. By contrast, in Japan, Germany, France and Britain—the four countries which disproved Mr Barro’s theory—public debt is under control.

Perhaps, therefore, the link between government borrowing and private savings depends on the private sector’s appraisal of the government’s policies. If public debt is already worryingly high, as in Italy, then a further increase in borrowing is likely to trigger fears of a future tax increase, prompting consumers to save more. If, on the other hand, public debt is relatively modest, taxpayers will be less sensitive to budget deficits. It would be good if things worked like this. Fiscal policy would be impotent for fiscally reckless governments, encouraging them to mend their ways; prudent governments could continue to use budgetary policy to steer demand.

Ricardian equivalence implies perfect foresight and information. In practice, future taxes and income are uncertain, so households may discount future taxes at a higher rate.

Ricardian equivalence assumes that all taxes are lump-sum taxes; in practice most taxes depend upon income or spending and so have disincentive effects on economic activity. Tax cuts will therefore stimulate output.

Parents may care only about the size of the bequest they leave to their heirs, rather than how much their heirs will be able to consume. If so, they will spend their tax cuts.

The perfect excuse

Why then has the Barro study proved so influential? One reason is that the theory was so elegant: by doing little more than laying bare a previously unexamined assumption, it threatened to overturn orthodox thinking on fiscal policy. Another is that Mr Barro’s theory commands enough empirical support to give mockers pause for thought (see box).

But the most important reason for the influence of the Barro theory is that, in a less extreme rendering, it offers an insight that is almost certainly true. Never mind about the effect of a tax cut on future generations. Ask instead about the effect on today’s consumers of a tax cut that is expected to be temporary. Taxpayers may well decide to save this year’s tax-cut windfall if they believe it will be clawed back next year.

Recently, interest in Mr Barro’s theory has, if anything, increased—especially in America. Conventional wisdom has long argued that America’s budget deficit is harmful to the economy. It has been blamed for America’s current-account deficit and high interest rates. Enter Ricardo. If, as Mr Barro argues, government borrowing cannot increase interest rates, crowd out investment or push up inflation, nobody need fret about America’s public borrowing.

This illustrates why Ricardian equivalence is unpalatable to Keynesians and fiscal conservatives alike: it implies that deficit financing is not only impotent, but also harmless. Keynesians believe governments can influence aggregate demand; traditional fiscal conservatives believe that budget deficits harm the economy through higher interest rates or inflation.

In fact, even if Mr Barro’s theory was right, governments could still do a lot of harm with their fiscal policy. The way in which governments finance their spending may not matter much, on Mr Barro’s view, but if that spending is itself too high, then the economy’s resources will be used inefficiently.

Today most economists still believe that fiscal policy does affect aggregate demand. They talk happily of “expansionary” or “contractionary” budgets. Do not be misled by that. Even those who scoff at the Ricardian-equivalence theorem have been influenced by it. Because of Mr Barro’s extremism, economists have reluctantly re-examined their ideas. As a result, few expect as much from the active use of fiscal policy as they used to.