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DEBT MANAGEMENT AND THE FISCAL BALANCE

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The management of government debt plays a key role in public finance. But the discussion of it is on the whole driven by political economy considerations. On the one hand, fiscal conservatives regard any government debt as a drain on future resources, and therefore to be avoided. On the other hand, Keynesians tend to dismiss concerns about government borrowing by arguing that the future growth assisted by debt-financed fiscal stimulus will allow the debt to be repaid. The conservative argument may be true of foreign borrowing, and even perhaps of domestic borrowing under a gold standard, but it is certainly not true of domestic borrowing in a credit economy. The Keynesian case, for its part, depends on assumptions about the fiscal multiplier that need to be backed by more than mere assertions that this ratio will be sufficient. Both cases need a more careful analysis of the principles and methods of government debt management and its effect on macroeconomic dynamics: the conservative case to show the resource constraints on government debt in a credit economy, and the Keynesian case to show the effective connections between government debt and the fiscal multiplier. This policy note provides such an analysis of domestic debt financed using fiscal principles derived from the work of Michał Kalecki.

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Debt Management and the Fiscal Balance

The government's budget may be divided up into a functional, or effective, budget and a financial budget. The functional or effective budget[1] contains all the government expenditure in the real economy (the provision of public services, welfare payments, and subsidies to economic activities) together with their financing by taxes on incomes and trade in the economy. The financial budget contains, on the expenditure side, the servicing of government debt and, on the income side, taxes on wealth (including financial assets) and taxes on profits:

fiscal budget =
    functional balance + balance of financial operations;

functional balance =
    government taxation of incomes and trade
    – government expenditure on goods, services, and
      welfare transfer payments;

balance of financial operations =
    government taxation of assets (real and financial)
    – government expenditure on debt interest

The functional balance is more obviously the economically effective one, because it is through this balance that incomes and expenditures are affected, for example through Keynesian fiscal stimulus or fiscal deflation. The financial budget merely affects the liquidity of private-sector portfolios and preferences about the composition of those portfolios, rather than macroeconomic variables such as income, expenditure, and employment.

This may be illustrated by Kalecki's proposal for deficit spending to maintain a high level of employment by means of a fiscal deficit, but with the annual cost of servicing government debt paid for by a wealth tax—or capital levy, or a tax on profits with appropriate deductions for investment—equal to the servicing required in that fiscal year. Wealthy individuals in general will pay these taxes. But the money will be returned to them in proportion to their holdings of government bonds.[2] If the financial budget is balanced, so that the tax to pay the cost of debt servicing is returned to the wealthy in the form of interest payments on the bonds, then the money in their portfolios remains the same, and the money markets can be relied upon to redistribute this liquidity in accordance with individual preferences. A crucial advantage of this kind of taxation is that it does not affect the incentives to invest, in the sense that the liability for it depends on the overall value of the wealthy's portfolio of assets, and not on the share of industrial assets in that portfolio. In the case of the profits tax, the calculation is a little more complicated. But a deduction for business investment can be calibrated in such a way as to maintain the calculated profitability of particular projects.[3] Kalecki's proposal of setting the financial balance at zero therefore represents a sustainable debt position that allows the government to engage in deficit financing of its functional or effective budget, while at the same time keeping up payments on its debt with a neutral effect on the liquidity of private-sector portfolios.

Debt Management and the Fiscal Multiplier

Dividing up the fiscal budget into a functional budget that affects the real economy and a financial budget that just maintains debt payments and the liquidity of the financial system overcomes the dilemma that makes fiscal policy ineffective—namely, whether the fiscal budget is to be used for macroeconomic management (the Keynesian position) or for debt management. By splitting the fiscal budget, the government can have two independent instruments that can be used to target, respectively, the macroeconomy and government debt, satisfying the Tinbergen rule of an independent instrument for every economic policy target. In this case, the targets are economic growth, using the instrument of the functional budget, and financial stability (debt management), using the instrument of the government's financial operations.

This feature of the budget arrangement can be illustrated by considering a situation where the financial balance (of wealth taxation and financial operations) is positive and greater than the functional fiscal deficit. This is the "expansionary fiscal contraction" that made a brief appearance in policy discussions a couple of years ago.[4] Because the financial budget is positive and exceeds the functional deficit, the government has an overall surplus with which to pay off some portion of its debt, while at the same time stimulating the economy with its functional deficit. In effect, monetary resources are being transferred from rentier capitalists (who are paying more in taxes than they are receiving back in interest on government debt and repayments) to entrepreneurs who are receiving as profits the amount of the functional fiscal deficit. The liquidity of rentier capitalists is modestly reduced by the difference between the financial budget surplus (which is taxed away from rentiers) and the overall fiscal surplus that

is returned to holders of government bonds in the process of paying off the national debt.[5] (Ex post, of course, the overall budget cannot have a surplus, since any excess of total revenue over total expenditure can only be transferred to the financial account—to buy and cancel government debt, or to buy other assets and, in this way, expand the government balance sheet.)

Somewhat more common than this expansionary fiscal contraction is what may be called a "contractionary fiscal expansion." This may be used to describe a situation in which a government's financial budget is in deficit, and a part of that deficit is financed by running a surplus in the functional budget. This kind of fiscal outcome typically results from considerations of "supply-side economics," in which wealth taxes are deemed to act as a disincentive to business enterprise and are therefore reduced. At the same time, attempts at reducing government expenditure in the functional budget are frustrated by the overall surplus in the functional budget that moves the economy into recession. Unless the surplus in the functional budget exceeds the deficit in the financial budget, the overall government budget remains in deficit, so that government debt continues to rise, with a growing financing requirement. Thus, efforts at stimulating economic growth through reduction in wealth taxation will fail.

Slow growth and rising government debt are not the only consequences of such supply-side policies. Since governments are contractually obliged to service their national debt, the deficit in the financial balance is in effect covered by the transfer of financial resources from the real (nonfinancial) economy into the portfolios of wealthy asset holders. The implication of a deficit in a government's financial balance is the rising liquidity in the portfolios of the wealthy. This rising liquidity makes the financial system less stable, as the overall situation of slow economic growth and rising government debt keeps the wealthy on the lookout for safer returns in other assets and currencies, no matter how delusory those returns may turn out to be.

The analysis in this policy note applies in the case of borrowing in domestic financial markets. The situation is of course considerably more problematic in the case of foreign borrowing. A fundamental advantage of domestic financing of government debt, as opposed to foreign borrowing, is that *domestic borrowing keeps financial resources within the economy*. Domestic borrowing merely recycles (increases the velocity of circulation of) existing money stocks, redistributing them among the wealthy who hold the largest monetary stocks. It fixes government borrowing on terms that the government itself determines through the central bank's control over interest rates. At the same time, the central bank's open market operations allow it to control the liquidity of the portfolios of the wealthy, so that government bonds may be "rolled over," limiting expenditures out of the financial budget to interest payments. With such government borrowing, it is not that future generations of taxpayers pay the cost of today's government expenditure, but future generations of taxpayers pay future generations of government bondholders (Toporowski forthcoming).

Conclusion

A government's debt management operations should not be viewed in isolation from taxes on wealth and profits. Combined with such taxation, debt management can be an independent instrument for managing the portfolios of the wealthy in such a way as to maintain the stability of the capital market and assure financing of fiscal deficits.

This fiscal-financial analysis suggests that economic stagnation in rich countries is not so much a failure of Keynesianism as a sign that the wealthy do not pay their dues toward servicing government debt, so that a government's financial resources are diverted from fiscal stimulus of the real economy toward financial circulation. At the same time, the financial instability that plagues poor countries may be because government debt is insufficiently domestic and the wealthy are, as in richer countries, insufficiently taxed to pay for debt servicing. A financial budget—servicing government debt from taxes on wealth and profits that do not affect incomes and expenditures in the economy—allows a government to manage its debts without compromising the economic goals set for fiscal policy in the functional budget.

A further conclusion from this analysis concerns the apportionment of taxes among different wealth and income classes. With rising government debt and annual debt service commitments, such a system of debt management implies that the incidence of taxation needs to be adjusted in a progressive direction to maintain the balance in the financial operations budget. If this is not done and the financial budget falls into deficit, then the redistribution from taxpayers to bondholders becomes regressive and the fiscal stance becomes contractionary, even if the overall fiscal balance is in deficit. This may be a factor in the recent differing assessments of the fiscal multiplier.

In sum, a disaggregation of the government's budget identifying a financial budget balance is critical not only for the financing of government debt, but also for the effectiveness of fiscal policy. A financial budget deficit diverts expenditure from the functional budget to financial circulation. So, whether it is the functional fiscal deficit or the total amount of non-debt expenditure that determines the value of the fiscal multiplier, the effectiveness of fiscal stimulus is reduced by the deficit in the financial balance. It requires little reflection to show that supply-side policies—reducing taxes on wealth, profits, and luxury consumption—have contributed to a decline in the fiscal multiplier and the economic efficiency of government finances.

Notes

1. The balance of the functional, or effective, budget may be called the primary balance. But it is perhaps slightly misleading to call this balance the primary balance, since this term is normally reserved for the fiscal balance *excluding* debt servicing, but including taxes on assets and profits.
2. "If full employment is maintained by government spending financed by borrowing, the national debt will continuously increase. This need not, however, involve any disturbances in output and employment, if the interest on the debt is financed by an annual capital tax. The current income, after payment of capital tax, of some capitalists will be lower and of some higher … but their aggregate income will remain unaltered" (Kalecki [1943]1990, 348); see also Toporowski (forthcoming). A wealth tax or capital levy as a means of covering a government's debt costs has a long record of support among economists, such as David Ricardo, Otto Bauer, Joseph Schumpeter, and J. A. Hobson, as well as John Maynard Keynes and Kalecki.
3. Such taxes can finance a growing debt service in a way that is "harmless in the sense that it will have no repercussions on output and employment" (Kalecki [1943]1997, 163).
4. See Nuti (2015) for a summary of the controversy around the fiscal multiplier.
5. Cf. "capital taxation is perhaps the best way to stimulate business and reduce unemployment. It has all the merits of financing state expenditure by borrowing, but it is distinguished from borrowing by the advantage of the state not becoming indebted" (Kalecki [1937]1990, 325).

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