Description of the Problem

The traditional and current dominant thinking is that budget deficits cause recessions. The ususal argument is that government borrowing (to finance its excess expenditures crowds out private borrowing by raising interest rates on private credit, thus reducing private investment and slowing the economic activity. The dominant economic thinking is deeply influenced by neoclassical ideas which have a blind faith in the markets. Neoclassical economists advocate the philosophy of free markets and free enterprise, which means less government intervention, i.e, privatization, deregulation and dismantling of all forms of administrative controls of prices and exchange rates. These ideas are more than a century old but in the 1990s they have become à la mode again.

In Canada, at least since the 1984 election of the conservative government, balancing the budget (and reducing the national debt) has been a top political priority. In order to achieve this goal, the government pursued tight monetary and fiscal policies, which meant massive cuts in social spending and public programmes. A general tendency of less government involvement in economic activity followed and selling crown corporations to private investors (i.e. privatization) proved to be an effective tool in disengaging the government from its historic responsibility of achieving full employment, guaranteeing UI for the unemployed (various changes to the 1971 UI Act in Canada made coverage less universal and access more difficult and limited), universal health care, education, etc.

Such policies have normally been associated with conservative governments, but in the 1990s the old cleavage between the left and the right has vanished. Liberals in Canada, Democrats in the USA, Labour in the UK and Socialists in France, etc. have all embraced the notion of "Balanced Budgets". This is a significant shift in economic thinking of the political elite because for almost three decades after World War II, Social Democratic Parties (Liberals, Democrats, etc.) advocated and -when in government- implemented, what has become known as Keynesian policies. During this period, most Western economies enjoyed rapid economic growth with low unemployment and rising labour force participation rates. The "Welfare State" took care of the unemployed, provided training, education and health care. Universal access to these services became a social and economic right that characterized Western democracies. Now, all that has changed. Why?

Orthodox economists argue that previous Welfare State entitlements are no longer affordable because when unemployment rises more people rely upon the social welfare system and fewer contribute to it, thus making it too expensive to sustain. Benefits have to be cut, taxes raised or both. Since the 1980s, control of debt-to-GDP ratios has been at the top of the political agenda in most countries, where governments (conservative, liberal or social democrats) have typically relied on the above fiscal orthodoxy in trying to reduce deficits, balance budgets or create surpluses.

The Liberal Party (in Canada) came to power in 1993 with the promise to reduce the budget deficit from 5.9% of GDP to less than 3% within three years. Since 1996 the target has become a balanced budget for the year 1998-99. Finance minister, Paul Martin has been trying very hard to achieve a balanced budget and he succeeded doing that by cutting billions of dollars from annual program spending. All Canadian provinces are working towards the same goal, i.e, to achieve a balanced budget. In Alberta, it is now illegal for the government to run a deficit. The government of Ontario is considering introducing a similar bill.

In the USA, both the Republicans and the President have made balanced-budget a top priority. In Europe, the Maastricht treaty has set very clearly the criteria for the European Monetary Union. To become members, European countries must reduce their annual deficits to less than three per cent (3%) of their GDP. In Africa, Asia and Latin America where these poorer countries are still in need of financial assistance from the international community, the IMF's famous conditionality rules require that funds will be released only when governments of borrowing countries cut their deficits, eliminate subsidies and other forms of government support to public programs, and liberalize their markets by allowing private (including foreign) investors into the public sector.

But are budget deficits really the culprits? A controversial issue such as this cannot be answered satisfactorily by relying on theoretical arguments alone. Empirical analysis based on hard facts is a necessary complement. Without going into details since the conference is intended to do just that - i.e, give detailed full arguments and analyses of economic experiences of several countries, I would like to report some important historical facts that bear a particularly significant meaning when we are addressing the issue of budget deficits and economic performance. These facts show that contrary to common belief, budget deficits are not a cause of recession, they are a source of stimuli to the economy.

In Canada:

Year net borrowing interest rates inflation as % of GDP (- means deficit)
1937 + 0.2 3.17 2.5
1944 -22.6 2.99 0.7

That is, with increased government spending (a large deficit in 1944), interest rates and inflation went down, not up as predicted by the "adversaries of deficits". A quick look at the history of public spending since the end of the second World War, shows that increases in the national debt and annual deficits do no harm the economy, they have always helped it. On the other hand, significant reductions in the debt and deficits have hurt the economy as evidenced by most recent events in Canada:

year net borrowing interest rates inflation Unemp rate as % of GDP
1981 -2.0 15.22 12.6 11.0 (1982)
1985 -7.5 11.04 4.0 10.5
1990 -4.33 14.1 5.5 10.4
1995 -4.82 8.3 2.5 9.5

Again, an increase in the deficit is associated with lower interest rates and lower inflation as is the case during the first half of the 1980s (1981-85). This is so because government deficits are a source of aggregate demand. By keeping aggregate spending at a high level, they prevent businesses from closing down and help workers keep their jobs and incomes, which are used to buy goods and services and that's how a recession can be avoided. Deficit reductions during the second half of the 1980s (1985-1990) were accompanied by higher interest rates (from 11% to 14%), more inflation and no improvement in the unemployment picture. Targeting a balanced budget for 1998-1999 is not helping the economy as the number of bankruptcies continues to grow:

Year	***Number of bankruptcies***
1990	11642
1991	13496
1992	14317
1993	12527
1994	11810
1995	13258
1996	14229

Source: Statistics Canada, CANSIM database.

Some important lessons can be learned from the experience of the USA as well. The data show that substantial deficit reductions have invariably led to recessions and that increases in public spending (deficits) have led to expansions:

See http://www.warrenmosler.com/

document #1: "Think big deficits cause recessions? Think again!" by Frederick C. Thayerdocument

#2: "A balanced budget is not the answer" by Michael Johns

So, is balanced budgets really the answer?