CAN WE AFFORD TO PAY FOR SOCIAL PROGRAMS?

John Smithin

Introduction  The purpose of this paper is to comment, from the point of view of an academic outsider, on what seems to have been the "realpolitik" of budget policy decisionmaking in federal and provincial jurisdictions in Canada (and in other jurisdictions with comparable systems of governance) in the recent past, through the 1990s and into the twenty-first century.

It should immediately be conceded that the interface of the academic theorist with this process is very limited. Essentially it is restricted, like everyone else, to reports in the print and electronic media, public documents, and such quasi-public events as the annual "pre-budget hearings" of the Standing Committee on Finance of the Federal House of Commons. It is therefore possible that behind closed doors, so to speak, these decisions are taken with a greater degree of sophistication and understanding of the economic processes involved than is immediately apparent. Failing some proof of this, however, it seems reasonable to suggest that the majority of persons involved in taking and commenting on such decisions literally believe that there is some kind of binding financial constraint operating at either the domestic or international level which restricts the total nominal amount of spending on various governmental programs, including social programs. It will be argued that this view is logically untenable in the case of a jurisdiction that issues a sovereign currency and has a floating exchange rate.

This is not to deny that there are severe political constraints on the total amount of spending that is undertaken. This is, in fact, exactly the point. What should be debated are precisely questions of income distribution and social fairness and the actual merits or otherwise of the various specific programs. What should not be an issue is what can be "afforded" in a purely financial sense. This paper argues that both the political process and the prosperity of the economy would be further ahead if these issues were upfront, rather than obscured
in one version or another of what Modigliani once dismissed as the “naïve burden” view, meaning the treatment of state finances as if they were analogous to those of an individual household. An obvious current example of this confusion, although not the only one, is the debate over whether or not “dollarization” or a “single currency” would be a good idea in North America. This is sometimes conducted (as in the analogous case in Europe) as if this has nothing to do with spending on social programs, fiscal policy, and so forth, whereas in reality in large part it can be seen as involving attempts to impose binding constraints on the sovereign governments, even where these did not exist beforehand.

Social Spending and Social Policy In such venues as the pre-budget consultations mentioned above, politicians clearly do hear first- or second-hand about some of the difficulties experienced in contemporary Canada by people who, for whatever reason, are economically disadvantaged in some way. An obvious starting point for discussions of, for example, the federal budget, is that many of these difficulties could be resolved either directly by increased federal spending or, in the case of overlapping political jurisdictions, by federal budget decisions which take the pressure off of other levels of government. Politicians’ basic response to this, however, is that it is easy for academics and others to say but that they are the ones who have to make the tough decisions; the number of good causes is potentially limitless, the public purse is not, and they must decide on the merits of every dollar of spending.

Presumably there should be general agreement that all decisions about spending projects should be taken on their merits. It is true, of course, that from the point of view of aggregate demand and as originally pointed out by Keynes in the General Theory, the spending of a dollar on a “wasteful” project will actually add to demand just as much as the spending of the same dollar on a supposedly useful initiative. As Keynes put it:

The above reasoning shows how ‘wasteful’ loan expenditure may nevertheless enrich the community on balance. Pyramid-building, earthquakes, even wars may serve to increase wealth, if the education of our statesmen on the principles of classical economics stands in the way of anything better.

It is curious how common sense, wriggling for an escape from absurd conclusions, has been apt to reach a preference for wholly ‘wasteful’ forms of expenditure rather than partly wasteful forms, which because they are not wholly wasteful, tend to
be judged on strict ‘business’ principles. ... the form of digging holes in the ground known as gold mining, which not only adds nothing whatever to the wealth of the world but involves the disutility of labour, is the most acceptable of all solutions.

If the Treasury were to fill old bottles with banknotes, bury them at suitable depths in disused coalmines which are then filled up to the surface with town rubbish, and leave it to private enterprise on well-tried principles of laissez-faire to dig the notes up again (the right to do so being obtained, of course, by tendering for leases of the note-bearing territory), there need be no unemployment, and with the help of the repercussions, the real income of the community, and its capital wealth also, would probably become a good deal greater than it actually is.\(^3\) (original emphasis)

Although the logic is unimpeachable, this is not a criterion that could reasonably be applied as a general guide for project evaluation in the public sector on political, ethical, and other grounds. Keynes himself went on to say that “(i)t would, indeed, be more sensible to build houses and the like; but if there are political and practical difficulties in the way of this, the above would be better than nothing.” At the most basic level, the point is that some of the proposed initiatives will likely do good in the social realm, others will not, and certain projects may be counterproductive. The responsibility of the decisionmakers is precisely to make difficult judgments of this sort. What is a matter of dispute, however (or should be) is whether the overall size of the public purse for a sovereign government, which presides over an independent monetary system and controls its own currency, can be decided by dubious analogies to the budget of a private individual.

It does, therefore, seem to be a matter of legitimate concern that the impression has been created in recent years that Canadian budget decisions seem not to have been made solely on their merits but also, even primarily, to achieve certain arbitrary financial goals. At one stage during the 1990s, for example, there was tremendous public concern about the size of the federal deficit which was greatly encouraged by the media, conservative “think tanks,” and the politicians themselves.\(^4\) Arbitrary targets were laid down that the ratio of the deficit to GDP should not exceed a certain figure. More recently, a budget surplus is seen as an unambiguously good thing and is actually regarded as a sign of successful economic management, in spite of the clear historical evidence to the contrary.\(^5\) The ultimate objective of fiscal policy is seen as simply to pay down the national debt (as distinguished from the annual deficit) at all costs.
The Role of Taxation Another notable feature of the contemporary public debate is the extent to which not only the governmental authorities, but also social advocacy groups of various political persuasions and particular interests, seem to have accepted the balanced budget norm as the framework within which to conduct the fiscal policy debate. Obviously if this is the case, then that debate will simply boil down to the question of how high the level of taxation should be. If there is to be more government spending on any particular program, then there must be correspondingly higher taxes. The following passage from a recent publication of the Canadian Auto Workers union (CAW-TCA) providing factual information for the “battle against tax cuts” illustrates the general line of reasoning:

The current debate over tax cuts in Canada will shape the nature of our society, and the quality of our life, for years to come... Giving back surpluses in the form of tax cuts will mostly benefit the upper-income earners who are already doing well. And those tax cuts will come with a heavy price: continued underfunding and near-crisis in our hospitals, our schools, even in basic infrastructure like our roads and water. The money should be reinvested in the public programs that improve our quality of life, and make our society ... more equal and inclusive.

In quoting from this source, the intention is not to criticize the research effort that went into its publication; in fact, the pamphlet provides a good deal of useful and sometimes surprising information about the Canadian tax system. In particular, and contrary to the popular impression, it shows that at that time the overall Canadian tax burden was less, and its incidence more fairly distributed, than in many other comparable jurisdictions. Also, the implicit critique of the popular view of a surplus is well-taken. What is apparent, however, is that the basic theory of public finance underlying the recommendations is more or less the same as that of political opponents who advocate less spending and tax cuts. The point being made is not simply that advocating higher taxes can be a difficult political strategy. More importantly, by arguing that spending must be “paid for,” the implication is that the viewpoint of neoclassical economics is thereby validated. The presumption is accepted that resources are inherently scarce, and that the question is whether or not any particular use of those resources can be justified. But, it is a shortage of money that is actually under discussion in budget policy, rather than any shortage of physical or human resources. And, as money is a social construct, a shortage of money can only be artificially created by an explicitly sociopolitical process.
Note that the following passage—published at approximately the same time by a research institution in the USA which (like the CAW-TCA) is generally regarded as left-of-centre in orientation—puts a completely different spin on the issue of tax cuts. According to the author, as of the date of publication “(t)here is already substantial evidence that the economy is moving towards a hard landing ... an immediate tax cut of approximately $450 billion will be required over the next year.” This was actually around three times larger than the tax cuts then proposed by the conservative US President George W. Bush, and would have lead to a deficit of around 2.5 percent of GDP. It was stressed, however (regarding the Social Security budget, for example) that, “an accounting deficit has no impact on the government’s ability to pay Social Security benefits, now or in the future.” Also, unlike the conservative arguments for tax cuts, it was explicitly recognized that a similar impact could be achieved with higher spending, holding taxes constant.

In raising the general issue of surpluses and deficits and whether or not taxes pay for higher spending, it should be noted that I, together with co-authors, have certainly been prepared to advocate higher taxes (along with higher expenditures) in situations where the balanced budget requirement is explicitly mandated by the sociolegal framework. For example, this is the case under the Maastricht Treaty and the egregiously misnamed Growth and Stability Pact in the Economic and Monetary Union (EMU) in Europe. In such circumstances, clearly, the old-fashioned textbook Keynesian balanced budget multiplier is the only remaining avenue for an expansionary fiscal policy in an individual jurisdiction under the politically enforced constraints. The same considerations do not apply, however, in the case of a sovereign authority with an independent monetary system.

Functional Finance? At one time it was widely understood that appeal to arbitrary financial constraints and objectives makes no sense in the context of the budget of a national government. Forty years ago, for example, the famous English economist Joan Robinson could write of the balanced budget “Treasury view” in Britain in the 1920s and 1930s that “nowadays this seems merely laughable.” And, indeed, these ideas would have seemed laughable, even from the point of view of the conventional wisdom, in the prosperous 1960s. But in our own time, the pendulum has swung back once again with a vengeance and, at the beginning of the twenty-first century, the ideas of current economic ortho-
doxy now differ little from those of 75 years ago derided by Robinson. In the broader political context, this is just one aspect of the “conservative revolution” in the Western world which took place in the last quarter of the twentieth century. In terms of what can be seen of the contemporary budget process from the outside, a long distance has been travelled from the original principles of “functional finance” as set out more than 50 years ago by such writers as Abba Lerner. These principles recognized that surpluses are not always good and deficits are not always bad, and explicitly stated that budget decisions should be taken with regard to their actual effects on the economy rather than their impact on financial ratios.

The main point to be recognized (recently taken up and stressed by the neoChartalist school) is the role of the state in money creation in the modern credit economy. The sovereign government in control of its own currency cannot, as a matter of logic, be constrained by purely financial considerations. If they claim to be, the constraints must be self-imposed. Contemporary neoChartalism is a modern revival of the ideas of Knapp, the originator of the state theory of money, and those of Keynes, both of whom use the term chartal in discussing the nature and functions of money. Also, Goodhart has argued that the chartalist view has considerably more empirical and historical verisimilitude than the rival neoclassical theory of money. In the modern literature, it is true that chartalist-type arguments have typically been associated with specific policy proposals, such as the “employer of last resort” (ELR) proposal for example, and that these may be controversial for reasons unconnected with the issue of financing. The concern of the present paper, however, is not with such debates, but with the underlying logic of the neoChartalist position and its general implications for public finance. Money is itself a social construct and, in practice, an artifact of the state and hence it is simply incorrect to argue that the state cannot acquire money and make expenditures until it has collected taxes from the public. The Chartalists do insist that some level of taxation is necessary in order to give “currency” to the liabilities of the state central bank, that is, to give the public an original reason for holding them. Hence the expression that “taxes drive money.” Also, tax changes themselves are seen as legitimate instruments of macroeconomic policy because of their impact on the spending decisions of individuals and firms. However, neither the taxes nor even bond sales are necessary to actually finance government expenditure. This can be done (and is done) simply by making available the money of the state to purchase what-
ever goods and services are offered for sale in terms of that money. Hence, given some basic level of taxation, the deficit can be of any size that is thought reasonable for macroeconomic policy purposes. According to Wray:

In the Chartalist approach, money is a creature of the state ... The state defines money as that which it accepts at public pay offices ... This has important policy implications. Once the state imposes a tax on its citizens, payable in a money over which it has the monopoly of issue, it can influence the value of that money by setting the conditions under which the population can obtain it. The government does not 'need' the money in order to spend; rather the public needs the government's money in order to pay taxes. This means that the government can 'buy' whatever is for sale in terms of that money merely by providing that money... (B)ecause the public will normally wish to hold some extra money, the government will normally have to spend more than it taxes; in other words the normal requirement is for a government deficit. Governments deficits do not require 'borrowing' by the government (bond sales); rather ... the government provides bonds to allow the public to hold interest-bearing alternatives to non-interest bearing government money. Thus the Chartalist view of money ... would lead to a very different view of appropriate monetary and fiscal policy goals. Most notably, it would be accepted that rather than striving for balanced budget, deficits would be accepted as the 'norm'. And ... monetary policy would recognize that its role is to establish the short-term interest rate.19

The argument, in short, is that as Canadian dollars originate with the Canadian government, the Canadian government cannot have any difficulty in acquiring them. The situation described above is admittedly not that of a provincial government, which always borrows in “foreign” currency (i.e., that of the central government), and to that extent does face an ultimate budget constraint. Nor could such statements be made even of those national governments in contemporary Europe, for example, which are members of the Euro-zone. In effect, the governments of these jurisdictions have voluntarily opted for provincial status, and in doing so have thereby artificially validated the strictures of neoclassical economics in their own case. However, none of these caveats applies to the government of Canada as long as a separate Canadian dollar continues to exist and is allowed to find its own level in the international financial markets.

It cannot be correct therefore for a government of Canada, of whatever political stripe, to claim that any particular policy initiative cannot be afforded, or that the money “cannot be found.” Money in this context is nothing but Canadian dollars, which the Bank of Canada can create at will, and does create at will every day. For the same reason, worrying about the size of a national debt,
which is also denominated in Canadian dollars, is a misplaced concern, at least in terms of where the money will come from to pay it back. From both the technical and ethical points of view, as stated above, what needs to be discussed is not affordability, but the merits or otherwise of the specific project concerned.

The Fear of Inflation

At this stage in the discussion, the problem of inflation is usually raised and this is of course (at least indirectly) exactly what the argument is all about. What is ultimately of concern is not really the spurious difficulty of raising the money, nor would it be even if tax rates were very much lower than they are today. What is at stake is the impact of any new money creation on the value of existing holdings of wealth. This, arguably, is the real point of impassioned editorials about debt, deficits, and inflation (and, for that matter, the low external value of the Canadian dollar) in the business and financial press. The worry is that the money created to finance the new spending will cause inflation and thereby reduce the real value of existing holdings of wealth, also denominated in dollars. Admittedly, however, the argument is not usually framed along the lines that more spending on social programs or the homeless is undesirable simply because it may devalue existing money in the bank accounts of, e.g., business corporations and wealthy individuals.

On this topic, one of the most informative sketches of the basic political economy of the system remains that by Keynes in an earlier book than the General Theory, namely his *Tract on Monetary Reform*.

In that work, Keynes examined the impact of unanticipated inflation on three broad classes or strata of society. These were an “investing class” of rentiers or financial capitalists, a “business class” of entrepreneurs, manufacturers and merchants, and the “earner” or labour. The hard-line methodological individualism of contemporary neoclassical economics might be supposed to preclude any useful modern equivalent to an approach along these lines, but Keynes anticipated the neoclassical objection that the threefold class division of income does not necessarily correspond to the individual distribution. He conceded that “the same individual may earn, deal and invest,” but nonetheless thought it important to investigate the effects of inflation on each of the different incomes sources, particularly in terms of the incentives to engage in each activity. It may also be true that the particular class divisions suggested by Keynes are now obsolete or outdated—the role of the investing class, for example, being played by pension funds and other institutional investors—and that of the business class by large corporations. If there is a basic continuity of capitalistic economic methods, however,
in the sense that Keynes's monetary environment of eighty years ago sufficiently resembles our own, it is still meaningful to discuss the effects of inflation on the incentives for the provision of financial capital, the organization of productive activity, and the supply of work effort, respectively.

Keynes's argument was that inflation need not be of much concern to either non-financial business or labour. In times of rising prices, labour has little difficulty in securing wage increases to match, while non-financial business may actually gain as the money value of stocks of finished goods and work-in-process appreciates on their hands. The financial interests, however, whose wealth is denominated in terms of money, do have a strong aversion to inflation. Strangely enough, given Keynes's later reputation in monetarist circles, he actually came out in favour of price stability as the best means to mediate these social conflicts.

However, a crucial point was glossed over in the original discussion and continues to be in the contemporary debate. Although the usual focus is on the impact of inflation as such, which is the obvious surface phenomenon, on a closer look it becomes clear that the underlying cause of conflict is actually the real interest rate changes that must occur as part and parcel of any attempt to change inflation by monetary means (the monetary policy instrument being the nominal rate set by the central bank). In the case of the business class, for example, for there to be any genuine profiteering from inflation, the real rate of interest must fall. Otherwise, in a continuing production process, refinancing next period's output at the new higher prices would eliminate the nominal profits obtained by selling today's goods at similarly higher prices. In the case of the earner, Keynes's argument was that labour can cope reasonably well with inflation itself. Nevertheless, labour does have a definite interest in the real interest rate changes that may be necessary to change inflation.

In the case of high real interest rates (designed to reduce inflation) there may be a tendency both for unemployment to rise and for real wages to fall. Even for financiers, it must be true that in any relatively sophisticated financial environment the real problem is not inflation as such, but the extent to which financial capital is protected from inflation, its real return. Very few individuals or institutions, after all, keep substantial quantities of the proverbial banknotes under the mattress. In a high inflation environment, a genuinely troubling circumstance from the rentier point of view would be if real interest rates were negative, so that the required inflation protection is not present. Significantly, this did occur in relatively recent history, in several jurisdictions during the 1970s. Therefore, although policy objectives tend to be articulated
in terms of targets for the inflation rate, the underlying point of contention may actually be the real rate of return on financial instruments itself. Worry about inflationary government spending and deficits, then, may not primarily be about the inflation itself, but the more urgent problem from the rentier point of view that existing wealth may not be sufficiently insulated from this.

**What Role for Monetary Policy?** The considerations discussed above do seem to illustrate that monetary policy itself would play a key role in any genuine attempt to ease the perceived constraints on fiscal policy. When real interest rates threatened to drop, or did drop, into negative territory around a quarter of a century ago in several jurisdictions, the political result was what I have called elsewhere the “revenge of the rentiers;” in other words, a drastic change in the conduct of economic policy (and the ideology of economic policy) to ensure that this situation would not continue. This upheaval in itself explains a good deal about the change in the prevailing views of both academic theorists and practical policymakers in recent times, and, obviously, the era of far higher real rates beginning in the 1980s. As opposed to this, as I have previously suggested, a commitment to low, stable but nonetheless positive, real rates of interest would provide an environment in which there would still be incentives for economic growth, but at the same time balancing the books would seem to be less of an imperative, debt service would not be seen as so much of a problem, and so on.

There are two aspects to this. As far as the political economy of inflation is concerned, by definition the value of existing wealth would be preserved in these circumstances (albeit not extravagantly rewarded), even if the inflation rate was positive. Therefore some of the political objections to a more expansionary fiscal policy discussed above may be muted. Also, it should be noted that the various theorems about the evolution of the debt/GDP ratio—dating back at least to the work of Domar—which raise fears that the ratio will rise exponentially with continued deficit financing, depend essentially on the relationship between real interest rates and GDP growth. If real rates are greater than GDP growth the debt burden will rise exponentially, otherwise not. If then, it is accepted that the level of interest rates is closely connected with the stance of monetary policy, and also that there is plausibly a functional relationship between real interest rates and growth (lower real rates leading to higher growth and vice versa), then the perceived budget crises themselves may also be seen as self-imposed to a large extent. If the central bank ratchets up interest rates in the
pursuit of other policy goals (as happened, for example, in Canada in the period of the zero inflation policy 1988-93) then clearly there will be larger deficits and growing debt, as the economy is simultaneously shrinking while interest payments on the debt are rising.\textsuperscript{26} The solution, however, would be simply not to deliberately put the economy under such deflationary pressure.

**Capital Flows and the Potential for Policy Autonomy for the Small Open Economy** Another common counterargument to the above would be that under modern conditions, and particularly as a result of greatly increased international capital mobility and “globalization,” the government of the contemporary small open economy (SOE) does not have a great deal of policy autonomy in any event, and has no choice but to conform to global market forces. Implicitly, however, the answer to this has already been indicated in the various references (above) to the importance of separate currencies, the relevance of the exchange rate arrangements, and the essentially provincial status of those governments that have agreed to join currency unions. It is the currency arrangements themselves that are decisive, and to a large extent the arguments about the inevitability of the disappearance of national economic sovereignty under contemporary global capitalism are disingenuous. They are often put forward by the advocates of policies, such as dollarization, that would ensure that this result will come about.

This argument has been dealt with in some detail in earlier work\textsuperscript{27} where it is argued that, even under modern conditions, the SOE with a floating exchange rate may still have considerable policy autonomy, provided that the local authorities have the necessary political will. The main point is that although globalization, increased capital flows and technical change do move the world ever closer to the textbook case of “perfect capital mobility,” as long as separate monetary systems and exchange rates are free to change, this still does not imply that there will be “perfect asset substitutability.” But it is the latter, not the former, which would need to hold for the domestic authorities to legitimately claim that their “hands are tied.” Otherwise a currency risk premium will continue to exist, and this can insert a wedge between domestic and foreign real interest rates, allowing for substantial interest rate autonomy as the domestic authorities manipulate the risk premium in their favour.

Of course, any type of national autonomy disappears entirely in the case of rigid fixed exchange rate regimes, currency boards and currency unions, which may be precisely why these arrangements are advocated in certain quarters.
Simply put, if the state controls its own currency, it has a lever over economic policy for all transactions conducted in that currency. If the control passes elsewhere, the policy initiative passes elsewhere also.

**Conclusion**  It is not the purpose of this paper to argue that every proposed government spending program is desirable, or that capitalism could survive as a social system if existing wealth is always under the threat of expropriation. However the short answer to the question posed in the title of this paper is, obviously, yes. Currently entrenched views to the effect that government budget deficits are always bad and surpluses are always good are not correct, and may be actively damaging. The logic of the capitalist monetary production process literally requires that some sectors of the economy must be continually willing to incur debt in order to generate positive monetary profits for others. If not the public sector, then some other group must be willing to incur debt, for example, consumers (e.g., by pushing credit card debt to the limit), or the corporate sector itself (cf. Keynes's “animal spirits”).

It is understandable that, in the present political climate, advocates of increased public expenditure for any purpose should seek to demonstrate that their proposals are as “fiscally responsible” as those of their neoconservative opponents. Also as mentioned, in certain circumstances in the contemporary world the rules of neoclassical economics have actually been written into the social legislation, often in the guise of the need to respond to globalization. The argument of this paper, however, is that according to the formerly accepted principles of functional finance, debates about whether or not spending projects can be afforded in the financial sense are essentially spurious, and should be replaced with debates about the rationale for the projects themselves, and their actual impact on the economy and income distribution.
Notes

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4. L. McQuaig, Shooting the Hippo: Death by Deficit and Other Canadian Myths (Toronto: Viking, 1995).
8. Ibid.
19. Ibid., pp. 18-19.
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22. Ibid., p. 5.
23. Smithin, Macroeconomic Policy, pp. 82-85.