

Integrating Sound Finance
with Functional Finance

by

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A major problem of fiscal policy is finding a balance between the short run stabilization goal and the long run systemic stability goal. Economists' debates about that balance have swung like a pendulum from a long run focus to a short run focus, back to a long run focus and... In the early 2000s, the debate is at the bottom of a swing and economists' views on fiscal policy are best described as chaotic. Among the majority of mainstream academic economists, short run discretionary fiscal policy is in ill repute both theoretically and practically. The general view held by most mainstream academic macro economists is that short run fiscal policy doesn't work, or that if it works, it works at the wrong time. The once accepted Keynesian theories of how fiscal policy worked have given way to a variety of theoretical models that provide little guidance to policy makers. These developments in theory mean that economists have given up their voice on budgeting, allowing political interests, not economic reasoning, to guide a practical fiscal policy.

While academic macro economists have generally given up their voice about fiscal policy, macro policy economists have not. However, for the most part today's macro-policy economists have given up any hope that fiscal policy can be used for short-run stabilization, and they have swung over to the long-run side of the pendulum. Given their negative view of the effectiveness of short-run fiscal policy, they have concentrated their efforts on implementing long-run systemic-

stability goals for fiscal policy. Their goal is to keep politicians away from the fiscal policy levers to maintain the long-run fiscal integrity of the state. What the goal of systemic stability is designed to prevent is a situation in which the government has approached its debt borrowing limit, and yet needs to run a deficit. In that case running a deficit will not even have the desired effect, since the deficit would likely undermine confidence in the economy, and have greater offsets in investment and domestic consumption spending than the stimulative government spending. So the reason to focus on the long-run systemic stability as a fiscal-policy goal is to preserve the option of using short-run fiscal policy when it is most needed.

Their advice has led to a variety of constitutional restrictions on budget deficits, such as US states' constitutional amendments against deficits, and the European Union's Stability and Growth Pact's constraint on the budget deficit relative to GDP. While macro-policy economists agree that these constraints undermine the short run-use of fiscal policy as a tool of stabilization, the current feeling seems to be that the cost is not great and one worth paying. Thus, those who feel differently, as is the case with most of the contributors to this volume, must either lower the political and economic cost of implementing fiscal stabilization policy, or convince others of its strength.

It is generally accepted that the current restrictions on fiscal policy have not found a good balance, and that often, in balancing the long-run and short-run aspects of budgets, these restrictions create a more perverse short-run fiscal policy than is necessary, with government spending policies contributing to recessions rather than helping to stop them, and exacerbating rather than slowing booms. The paper discusses a proposal that would help in achieving a better

balance between the two. Specifically, it proposes a change in governments' budgeting procedures from an annual budget to a moving-average budget, in which government uses a three-year rolling average budgeting procedure (with a underlying trend rate of increase built into it) rather than an annual budget for any rule restricting fiscal policy. It argues that specifying all legal long-term budget restraints in terms of this moving average, rather than in terms of a yearly budget, would reduce the perverse effects the long-run budget restrictions currently bring about. Thus, this paper offers a complement to Seidman's (2003) recent discussion of methods to reintroduce fiscal stabilization policy into policy.

The paper first presents a short history of fiscal policy. Second, it presents an even shorter history of the politics of fiscal policy. Third, it discusses the nature of the moving-average proposal and how the adoption of such a budgeting procedure would avoid some of problems that are currently plaguing the use of fiscal policy and how the proposal, had it been in effect, would have changed the decisions facing governments.

A Short History of Fiscal Policy

Economists' view of fiscal policy's usefulness has fluctuated widely. Before the 1930s fiscal policy was not part of the lexicon of economists; government spending policy was discussed under the name sound finance – which held that the government budget should be balanced except in wartime. This view was primarily held on political, not economic grounds, although government spending was not large relative to total spending, and thus would not have a large stabilization effect in any case. The classical liberal tradition viewed government with suspicion, so any policy that would make it easier to increase government spending during peacetime was

seen as undesirable. Sound finance principles made increasing government spending difficult, and forced government to face the costs of a spending decision simultaneously with the benefits of that spending decision, something that bond finance did not do. Economists recognized that government spending could impact the state of the economy and that, at times, unbalanced budgets could make sense, but they felt that long-run fiscal integrity of the government should override such concerns in peacetime. That long-run fiscal integrity would allow the government to have a cushion to finance a war. For Classical economists, allowing government the option of deficit spending in peacetime was similar to giving a credit card to a spendthrift child.

In the 1920s in Europe, and the 1930s in the United States, economists, such as A.C. Pigou, F. Knight, and J.M. Keynes, started questioning sound-finance principles as the economies of the world fell into a major ongoing depression, from which there seemed no escape. The depressed state of the economy created a vicious circle in which the expectations of continued depression kept investment spending low and became self-fulfilling. Given such a collapse of economic expectations, they favored, at least temporarily, giving up the sound finance principles and using government spending to stimulate the economy.

These economists' support for deficit spending was based on simple common sense reasoning, not complex underlying models; it seemed reasonable to assume that if the government spent more than it took in – ran a deficit – that the economy would be jump started; income would increase; the recipients of that increased income would spend more, creating a virtuous circle that ultimately would help pull the economy out of the recession. There were questions of how much offset would result from financing the deficit, but there was a general feeling among

policy-making economists was that fiscal policy could be of some use in helping pull an economy out of a severe recession and possibly even in offsetting undesirable cyclical fluctuations in output.

These changing views of the deficit were soon subsumed under the Keynesian revolution. This was unfortunate for both the Keynesian revolution and for fiscal policy because it intertwined abstract theory with pragmatic policy, obscuring both. The reality is that Keynes' *General Theory* was not about fiscal policy at all, and does not mention it as a policy tool. Keynes' support of fiscal policy predated the *General Theory* and was not dependent on it. Moreover, he maintained many of the Classical views about fiscal policy long after he wrote the *General Theory*. However, the practical and theoretical debates soon merged into a debate about "Keynesian policy." The reasons why were in large part political. Business leaders in the 1930s recognized that there was a serious problem in the Depression, and that if something were not done, it was unlikely that our economic system would continue. Given the options, liberal business leaders felt that running government budget deficits could help stimulate their demand, and was the type of intervention that would have the least effect on them. They saw it as a way to save capitalism with the least amount of government intervention.

Liberal politicians pushing for new government programs such as social security and welfare programs felt that the acceptance of deficit finance could make their introduction easier. So, they jumped on the fiscal-policy interpretation of Keynesian economics because it helped with their other goals. Thus, in our view fiscal policy was accepted because it was a conservative policy that limited government involvement in the economy, especially when compared to Keynes'

proposal in the *General Theory* for socializing investment. So the debate about Keynesian policy quickly shifted to a debate about fiscal policy.

The acceptance of the fiscal-policy tool and the effectiveness of fiscal policy did not come easily. Since Keynes had not discussed fiscal policy in the *General Theory*, much of that early debate was focused on Abba Lerner's rendition of Keynesian policy (1941) that reduced it down to specific rules about monetary and fiscal policy, which he called functional finance.

Lerner was a brilliant pedagogue, and had a wonderful way of providing clear mental models that made the policies he advocated seem obvious, even if at first they seemed counterintuitive. In proposing these rules of functional finance, Lerner's stated purpose was to shift thinking about government finance from principles of sound finance that might make sense for individuals – such as a balanced budget – to *functional* finance principles that make sense for the aggregate economy in which government spending and taxing decisions affect levels of economic activity. In doing so he hoped to change the focus on the *consequences* of government financing, not on the then generally accepted, but little considered, rules of sound finance and the quantity theory of money.

In making his arguments he created a famous analogy, which saw fiscal policy as a steering wheel driving the economy. Functional finance meant using the steering wheel to guide the economy and keep it going straight; sound finance left the economy to bounce around on its own crashing again and again. The clearness of Lerner's writing, and the neatness of his models, made Lerner's story of Keynesian economics the textbook story.

Unfortunately pedagogical simplicity comes at a cost and in specifying these rules of functional finance Lerner simply ignored the broader arguments for sound finance, and ridiculed the balanced budget mentality of sound finance. He argued that any level of deficit and debt were possible, and that taxes should be chosen to achieve the desired level of income, not to bring in money to pay for government expenditures. Any level of government expenditures could be paid for by selling bonds or printing money – the important point was to spend to the level that would achieve full employment.¹ The only reason to tax was to fight inflation, not to finance expenditures.

Lerner's initial specification of the rules of functional finance assumed that the government's inflation and employment goals were simultaneously achievable. But it was soon found that they were not, and that therefore, generally, the rules of functional finance provided contradictory guidance. Inflation required expansionary fiscal policy; unemployment required contractionary fiscal policy, and Lerner had no rule for what to do when there was simultaneous inflation and unemployment.² Moreover, it was also quickly discovered that politicians, not economists, controlled the levers of fiscal policy and their imperatives for staying in office made the use of politically discretionary fiscal stabilization highly questionable. The drivers of the economic car were not economists, but groups of politicians grabbing at the steering wheel, and staying on the economic road was not their primary concern. So stagflation and the realities of politics soon led to a movement away from fiscal policy in both the texts and in macro policy.

First to go was the sense that the government could use fiscal policy to fine-tune the economy, and by the 1960s fine-tuning was no longer part of the textbook story. Fiscal policy could still be used in serious cases of recession or boom, but it certainly shouldn't be seen as a steering wheel. Among practicing macro economists, the second aspect of Lernerian philosophy to go was the position that the amount of debt did not matter. Most economists came to believe that it did matter because of sustainability goal; deficits have to be financed, and the financing issues ultimately place a limit on how large, and for how long, deficits can be run.

The largest fear of sustainability involves default and fear of default – where the government in question does not have the capacity to service the existing debt, or where individuals believe that the government will not have the capacity or will to do so. In this case the government may be unable to sell its bonds, leading it technically into default. If a sovereign default occurred, the solution would be either a bailout by some higher level or extra-governmental organization, or a breakdown and reestablishment of the economic system.

The debt limit is stricter for governments without a monetary authority to bail out the government if they can no longer sell their bonds. But even those governments with monetary authorities face a limit either because of international commitments on monetary policy that limit the monetary authority, or because of fear of the hyperinflation that results from such bailouts at some level. The level of these limits is ambiguous; they bite only in the uncertain future. Thus individuals can differ on where these limits are. But the academic legacy of function finance literature is that these limits, not some mystical nature of deficits, are the reason to fear deficits.

Today, these issues are well understood by macro policy economics, and good ones (the ones who agree with us) favor a policy that might be called *sound functional finance*, a policy that considers all these issues and tries to find a balance between the short run and long run goals.³ Since short-run fiscal policy for stabilization purposes does not seem especially doable, many practicing macro economists turned their focus on fiscal policy on achieving these long run goals to avoid sovereign default. This focus on long-run goals is not, however, a return to the pre-Lernerian days of sound finances. In the current macro policy view, sound long-run finance need not involve a balanced budget; the short-run and intertemporal financing advantages of deficit finance are recognized, and built into the policy advice that policy-oriented macro economists give as they try to find a balance between the long-run and short-run goals. The general view is that rather than a balanced budget it is better to specify any long-run limitation on deficits relative to the taxing capacity of the government. Since GDP serves as a measure of the taxing capacity of the government, the limits are generally estimated by debt-to-GDP ratios.

While this evolution in policy economist's thinking about fiscal policy was going on significant changes were occurring in macro theorists' thinking as well. In these theoretical reconsiderations, not only was functional finance coming under attack; so too was the entire foundation of the Keynesian model. These attacks were so successful that by the 1990s, with the development of new classical economics, rational expectations and Ricardian equivalence, any sense that fiscal policy had a formal theoretical foundation dissolved. The new synthesis in macroeconomic theory sees macro problems within intertemporal dynamic stochastic general equilibrium models. These models of infinitely rational individuals generally come to the not surprising conclusion that deficits have no first-order impact. In an ongoing system you've got to

pay for something sometime, so deficit finance is simply a rearrangement of expenditures and tax payments, which individuals can take into account and offset in their own, or their offspring's spending patterns. Ricardian equivalence tells us that financing does not matter; it is all the same. In these modern theories deficits are simply budgeting procedures that in an economy in intertemporal equilibrium, do not matter. Thus in these theoretical models, deficits make little difference, since rational agents will simply reallocate their intertemporal spending decisions to offset any government change.⁴

Most policy economists pay only slight attention to theorists, and they continued to see deficit issues in terms of finding the correct mixture of long-run fiscal restraint and short-run stabilization needs. But with the loss of any theoretical backing, their views became just one in many, and pop economic philosophies, such as supply-side economics, developed that rationalized political uses of the budget deficit. There were so many different views coming from economists that their views simply stopped being important, except to the extent that politicians wanted to use one view or another to support what they wanted to do anyway. The politicians decided that fiscal policy, and in the absence of any consistent guidance from economists on the budget, the political positions of various parties moved away from reflecting economists' recommendations, and towards the position that gave them the best political advantage.

The Politics of Fiscal Policy

Let us now turn to a brief history of the politics of fiscal policy, focusing on the US and relating it to the Republican's and Democrat's positions on deficits. Prior to the 1930s all politicians – Democrats and Republicans alike – were against deficits; the general view held by politicians

was similar to that held by classical economists. They believed that deficit financing was to be reserved for wartime, and that in peacetime debt incurred during war would be eliminated. As we alluded to in the beginning of the paper, that view changed in the 1930s because of the severity of the economic slump. Roosevelt and the New Deal programs began a program of small deficit spending even while maintaining the rhetoric of sound finance. That change occurred as pragmatic economists of various political persuasions began considering bond-financed public works spending as a way to pull the economy out of the 1930s depression. Sound finance and concern about the long-run implications became questionable when the short-run depression left the short-run existence of the economic system in doubt.⁵

The arguments for deficits caught on among academic macro economists in the US in 1937, when the recovery, which had been ongoing since 1933, ended and unemployment increased, even though it was still at high levels. At that point, the political views about deficits began to shift.

World War II stopped the debate about the use of deficits as a stimulatory tool, and the economic debate turned to the problems of financing the war, and how big deficits could be run. In this debate there was little thought of sound finance, since in war time, with the survival of the state in question, deficits had always been acceptable. The war period was marked by large deficits, decreases in unemployment, significant labor shortages, and large growth rates in output. In the eyes of many the power of deficits had been demonstrated by war finance.

When the war ended in the late 1940s, both economists and politicians began to deal with the question of fiscal policy during peacetime. Many believed that the economy would fall back into depression, which was seen as a characteristic of mature capitalist economies, and that large government deficits were necessary to counteract secular stagnation. It was that time that functional finance caught on and the debate about deficits merged with the debate about Keynesian economics.

Initially, in the 1950s and early 1960s, the political sides were clear; the Democrats were Keynesian; they were the party of the deficits. Republicans were Classical; they were the party of sound finance. Consistent with these positions, Democrats pushed for increases in government programs and government spending, in part justifying these programs as increasing the size of the government budget and thereby increasing effectiveness of fiscal policy as a tool of stabilization. For example Alvin Hansen wrote that the welfare state involves “government outlays large enough to permit fiscal policy to play a controlling role in the adjustment of aggregate demand to the productive potential of which the private enterprise economy is capable.” (Hansen, 1957, p. 37)

The push by Democrats for increased spending was partly offset by Republicans who pushed for tax decreases, but that push was often overwhelmed by their support of sound finance.

Ultimately, Republicans found that they had to compromise on their support for sound finance and accept some level of deficits, because of the political difficulty of cutting government programs once they were started. During this time, the relative size of the government increased, and almost continual deficits were run. However, these deficits were not especially large relative

to GDP, and no serious economist felt that these deficits were raising questions about the long-run financial viability of the state.

The politics of government budgets was made easier during this time period by growth and creeping inflation. Growth meant that tax revenues were increasing each year, which provided a growth dividend, and that also allowed an increasing debt even while maintaining a constant debt-to-GDP ratio. The creeping inflation similarly reduced the real debt and the debt-to-GDP ratio. This creeping inflation interacted with the progressive income tax to effectively raise the tax rate on individuals without any tax increase, thereby providing an increasing share of income going to the state, even without government specifically increasing taxes. This institutional structure allowed there to be continual deficits, and much talk about deficits, but no real concern about the deficits' effect on the long run fiscal position of the US, which remained solid during this entire period. Thus, in the 1950s we had reached a type of political/economic equilibrium with Democrats increasing government programs and spending, and Republicans divided in their support of tax reductions and eliminating deficits. Thus, from the 1950s to 1970s government spending increased, government tax rates were reduced, and deficits were run at a level that kept the US in the middle of the ranking of countries in debt-to-GDP ratios, leaving significant borrowing capacity for the US government. On the state level, balanced budget requirements in the constitutions kept state government deficits in check, although numerous ways around these requirements were found.

The political equilibrium changed in the 1980s when the Republicans moved philosophically away from their support of a balanced budget, and began to focus solely on tax reductions. The

underlying theory behind that shift was often associated with the supply-side proposition that tax cuts would increase incentives for work and investment so much that it would create growth, but few serious economists believed in the strong supply-side arguments. Instead, the sophisticated Republican reasoning was subtler and more political. Essentially, it was that government spending was enormously inefficient and needed to be kept down. It also held that political forces would work to spend whatever money was available. This meant that a budget surplus, or even a deficit that did not exceed a certain level of GDP that would alarm the public, was an invitation for increased government spending. These two propositions led Republicans to eliminate their support of sound finance and a balanced budget. The new Republican supply-side position became one of “always cut taxes,” and “never raise taxes.” This Republican position came into being with the Reagan era; Bush the Elder violated it and his loss to Clinton was attributed to that violation, making the “tax-cut” philosophy deeply entrenched in the Republican view. This left fiscally conservative Democrats, and a few maverick Republicans, as the few reluctant supporters of sound finance, and pushed deficits higher in the 1980s.

Fear about the long-run viability of Social Security and Medicare programs, and the public’s general fear of deficits led to a variety of pay-go programs to limit government spending and tax cuts and create a stronger long-run fiscal balance. But the accounting and economic issues underlying these were poorly understood by the public, and they had been written with only deficits in mind. When the economic boom of the late 1990s, combined with demographics of the baby boom, started to lead to large government budget surpluses, these pay-go programs were not renewed, and in 2002 the programs expired with hardly a mention by either side or the press. This removed the last constraint on the previous political/economic equilibrium, and

opened the way for larger and larger deficits with few institutional constraints, whether or not they were needed as a fiscal stimulus.

The effects of this change in the political/economic equilibrium occurred much faster than most observer believed possible. With President Bush's election, the ending of the economic boom, the tax cuts Bush pushed through, and the increases in both social and defense spending, the seemingly large surpluses that had been predicted at the beginning of the 2000s evaporated, and were replaced by large deficits. With inflation low, these deficits were real, not nominal. Deficits relative to GDP increased, bringing back concern about sound finance and the long-run consequences of deficits. The US is, of course, a long way from its long-run limit on its borrowing capacity; it has trillions of dollars of leeway left, but with the change in the political/economic equilibrium that has led to possible \$600 billion dollar annual deficits, it will likely use up that leeway faster than many expect.

Given the current political postures of both Republicans and Democrats, more and more policy macroeconomists have come to the conclusion that some type of long-run fiscal restraint is needed. It was that concern that led to the Stability and Growth Pact in the European Union, and to constitutional amendments of states limiting budget deficits. The problem of these long-run restraints is that they affect the political/economic equilibrium in a perverse way, leading to pro-cyclical rather than anti-cyclical spending. They mean that whenever there is a slowdown in the economy, governments must cut spending, taxes must be increased, or both. This pro-cyclical state and local fiscal policy works on the up side as well. As the US economy boomed through the 1990s most state governments increased their spending or cut their taxes, maintaining only a

small rainy-day fund. As they did so they contributed to the boom, and kept the economy going at a rate that was unsustainable. Such pro-cyclical fiscal policy is bad for the states and bad for the national economy.

The problem is that these long-run constraints force the political system to take deficit spending into account precisely when taking it into account will have the wrong short-run effect – when the economy is going into a recession. One wants a solution that forces government to take the long-run fiscal consequences into account when the economy is in a boom – running larger surpluses in those booms. A modification of the pay-go system is one way to achieve this. It could specify that government spending restrictions become stricter when the economy is above trend, and looser when the economy is below trend, but such a change is complicated to specify and will likely be difficult to implement politically.

A Proposal for a Moving Average Budget

With that background, let us now consider the reasoning behind the proposal being suggested in this paper. It is a proposal, which we call a *moving-average budgeting proposal*, that extends the term upon which the deficit is calculated to a minimum of a three-year period, and possibly to a five-year period. Thus, in calculating the deficit, a moving average revenue period would be used.⁶ A moving average budget is a budget in which revenue flows are smoothed out so that spending depends on a moving average of revenues rather than yearly revenues. Thus the spending and tax cut limit determined by the budget is only partially determined by revenues in the current year, and are instead determined by revenues in past years. A moving average budget smoothes out revenue flows so that upward and downward adjustments are spread out over three

years, rather than being made in the year. Thus, if the economy is in a boom, spendable revenues will not rise as fast as they otherwise would, and if the economy is in a recession, spendable revenues will not fall as fast as they otherwise would. If any long-run spending restriction is based on this moving-average budget, its short run pro-cyclical effects will be partially offset.

What this proposal does is to build in a rainy-season fund into the budgeting procedures by presenting the budget as one in which it automatically keeps a portion of a large increase in revenues out of the current budget. Similarly, where there is a decrease in expenditures, it keeps a portion of a decrease in revenues out of the budget so that cuts do not have to be made immediately, but instead can be spread out over a period of time. If the economy rebounds in the next time period, the spending can be increased. By using moving-average budget figures in any long-run constitutional limit on deficits, one incorporates some anti-cyclical spending into those budgeting procedures. It is an automatic stabilizer, but it is an automatic stabilizer that is not only built into the spending and taxing provisions, but into the budget itself.

The first thing to note about this proposal is that it is a proposal about budgeting procedures, not about fiscal policy. Choosing a year as the period over which to consider the state of the budget is simply an arbitrary choice that is designed to smooth out revenues and expenditure flows; few would argue that daily, weekly or monthly budgets should be balanced, or even considered since there is unevenness in both revenues and expenditures. A yearly, rather than a monthly, budget simply extends the period that is smoothed from monthly budgets to yearly budgets. A moving average budget extends it to a longer period. As long as the random fluctuations in revenues and expenditures are of shorter duration than the smoothing period, a moving-average budget rule,

rather than a shorter-term budget rule, will introduce stabilizing fiscal policy into the budgeting procedures. The second thing to note about the moving-average budget is that its goal is to affect the political/economic equilibrium and how that equilibrium affects the focus that the political system gives to the long-run and short-run goals of the economy.

Our support for introducing a moving-average budgeting procedure is based on two propositions. The first proposition is that while budget procedures are only accounting phenomena; and do not *directly* affect the real economy, those budgeting procedures do *indirectly* affect real forces through their effect on people's psychology and politics. Thus policy must consider that indirect effect. Our point is that the way in which information is presented can cause people to react quite differently. Thus, budgeting procedures are important and ideally should be designed to reflect the underlying realities of the budgeting choices as best they can. We call this proposition as it relates to the long-run borrowing capacity of the government *the principle of sound finance*.

The second proposition that the proposal is built upon is the *principle of functional finance*. This principle concerns the ability of short-run budget deficits to be stimulative, because of their ability to put spending power in the hands of individuals. There is an enormous amount of theoretical and empirical work that has been done on this effect, and most of the empirical evidence suggests a small, but highly variable, positive effect in the short-run and a possible slightly negative long-run effect of a deficit due to the higher interest rates it may cause. The size of this effect will be highly uncertain, because these fiscal policy levers work significantly through expectations and consumer and investment psychology, but it will generally be there. Assuming it is, other things equal, relative to ones long-run sound-finance principle, in

downturns one wants fiscal policy to be relatively stimulative, and in upturns one wants it to be relatively contractionary. For that reason we expect that politically, there will be strong pushes for budget deficits whenever the economy slows. The problem is the lags in implementing discretionary fiscal policy make it almost unusable, which is why Larry Seidman (2003) has revived the arguments for built-in stabilizers that increase the deficit in contractions and decrease the deficit in expansions. The methods Seidman suggests include formula flexibility, a fiscal policy board, and establishing fiscal discipline with a normal-unemployment budget-balance rule (a variation of a rule focused on the structural rather than the cyclical deficit).

Our policy proposal operates in a similar way to formula flexibility, but it changes the very definition of deficit and surplus, and thus incorporates the stabilization into the budget procedure and the definition of deficit and surplus. It should be seen as an additional tool that can lead to a better mix of the goals. The advantage of the moving-average proposal is that it doesn't involve establishing a board, or affect tax rates, which are likely to be politically contentious. Moreover, since it takes no position on what the fiscal policy should be, but is nonetheless likely to push government toward a better balance between sound and functional finance goals of fiscal policy, it should be more politically feasible than the methods Seidman discusses.

As we stated above, this proposal should not be seen as an alternative to those other policies, but as a complement. It is also a complement to the policies that have been advanced to achieve better focus on sound finance goals, such as pay-go systems and capital-budgeting procedures. Our proposal simply involves a change in budgeting procedures; it is neutral as to the balance that government chooses between the sound and functional finance goals. Any discretionary

fiscal policy can be used with it. How then will it affect the actual fiscal policy that is used? We see it working through its effect on changing the political forces that govern the spending and taxing decisions. *It gives more focus to the sound finance principle in booms and expansions, and more focus to short run goals in recessions, and thus finds a better balance between the two.*

To see the degree to which a moving average budget would stabilize revenues, depending on the nature of the fluctuations and the length of the moving average, consider the example of fluctuating flows of income and constant expenditures (of 100) shown in Table 1.

[Table 1 about here]

In the first year the 33 percent fall in income was reduced to a 20 percent fall, and in the second the 50 percent rise in income was reduced to a 6.6 percent rise in income, and so on. Thus, by using a moving-average budget, the variance of a flow of revenue available for spending can be reduced. In terms of the budget deficit or surplus, notice that it changes significantly. For example in year seven, the current budget deficit is zero, but the moving-average budget deficit is 14.3. Thus during this expansion, rather than the deficit not existing because of the expansion, encouraging increased spending, the budget is in deficit, reflecting the shortfall in revenue in the two previous years. That meant in years six and seven, when the economy was in a recession, the deficits were much less, and therefore there would have been less pressure to make the drastic cuts.

Instituting a moving-average budget with an unknown trend makes the underlying theory even more difficult, and presents the problem of deciding if a trend is changing or whether one is experiencing cyclical fluctuations around that trend. But these are technical issues, and are issues that have been studied significantly in the detrending literature; thus we believe that reasonable procedures can be built into the proposal. But as with many such proposals, perfection is the enemy of the politically feasible, and a simple moving-average procedure around a long-run trend may be the easiest to explain and gain political support for.

Conclusion

The problem of integrating the short-run stabilization and long-run systemic stabilities of government's fiscal policy is an ongoing one. It was not a serious problem for much of the latter twentieth century for the US because of a political/economic equilibrium that developed. Over the last couple of decades, that equilibrium has broken down, and a current problem of fiscal policy is how to integrate these. One current method of integrating them – instituting restrictions on deficits – works pro-cyclically, and often worsens the fluctuations. One way to reduce the anti-cyclical nature of the problem is to change our budgeting procedures to use moving-average revenues rather than current revenues in the calculations of budget-deficit restrictions and in the budgeting decision of the government.

These budgeting procedures matter, not because they matter inherently, but because they play a role in the political pressures which ultimately determine the fiscal policy of a country.

Budgeting procedures must be considered in relation to the political/economic equilibrium that they will bring about. Moving-average budget procedures combine the long-run and the short-

run dimensions of the budget process into the budget and the definition of deficit, and thereby make the reported concept of deficit better reflect the combination of long-run and short-run effects of the budget. Thus, if one is going to require some balance in a budget either absolutely, or as specified as a percentage of GDP, that balance is best specified on a moving-average budget, rather than a yearly budget. While there will still be pressures to deviate from the rule, the pressures will be less likely to undermine the initial goal of the budgeting procedure.

We fully agree that the proposal is simply an accounting change; it does not change the underlying nature of the system. Moreover, we also agree that it could be duplicated with the creation of a rainy-season fund, or by appropriate decisions on spending that take functional finance considerations into account. But the problem with these alternatives is that politically, they do not work. An effective rainy-day fund has always been politically too tempting a target in a downturn, and politically too difficult to set up in a boom. To be effective rainy-day funds have to be much larger than anything currently conceived. They would be better seen as rainy-season funds, rather than rainy-day funds.

The moving-average budget is a change in budgeting procedure; it says nothing about what the fiscal goal of governments should be or how governments should balance functional finance and sound finance goals. It is simply meant to change when those considerations are taken into account. It is designed to lead governments to consider long-run goals more heavily in expansions, and short-run goals more in contractions. It is a budgeting procedure that can be associated with a variety of long-run spending restraint programs, or with no such program. All it does is to make whatever long-run fiscal restraint one imposes less likely to be pro-cyclical and

more likely to be anti-cyclical. It is not the solution to the fiscal policy problem, but it is a small change that would help better integrate the long-run and short-run dimensions of fiscal policy into the politics of budgets.

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¹ Most economists of the time, including Keynes, had a hard time accepting Lerner’s stark presentation of the argument. See Colander (1984).

² Actually, Lerner latter had a proposal for how to deal with stagflation, but politically that was not adopted. See Lerner and Colander (1980) and Colander (1979, 1986).

³ We can see the various ways in which these issues play out in the current debate about the Stability and Growth Pact in the EU and in the problems of the state governments in the US, where constitutional laws in all but one state make deficits unconstitutional. However, the laws are often not followed either through accounting tricks or through outright refusal to follow them, as is currently occurring with the Stability and Growth Pact.

⁴ It is important to note that this shift in theoretical thinking about fiscal policy is not a movement back to the Classical position of sound finance, which provided a strong moral voice for balancing the budget. It was a post-modern voice that nothing mattered; it all comes out in the market wash.

⁵ This, in our view, was what Keynes was refereeing to in his famous “in the long run we are all dead” statement; it meant that if we don’t solve our short-run problems that can undermine the system, there would be no long run.

⁶ While the technical aspects of the policy are not the subject of this paper, we would expect that it most likely would be implemented quarterly, so that with a three-year moving average, every quarter the latest quarter would replace a quarter three years ago in calculating the deficit.