Intersectoral balance and the fiscal stance

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The state is not a household or a firm

- If it were a microeconomic unit it could maximise a self-focused objective function without regard to the external (spillover) effects of its actions on other players in the economy

- But because the state is a big player,
  i. external effects of its behaviour are central to understanding its wider role and impact
  ii. accounting concepts such as “net worth” don’t make much sense (the state’s asset portfolio as a whole can’t be realised by a liquidation sale)

- And because the state is pursuing non-pecuniary outcomes
  i. “prudence” and “responsibility” become tricky concepts
  ii. setting policy “as if” the state is profit-maximising involves a category error

Outline

My focus is on the interface and interaction between the state (public sector) and the private sector

1. Interrelation of sector financial balances in an open economy: consumption, saving, investment, tax and government spending, the balance of payments

2. Measuring the size of the state depends on how the boundary is defined: a criticism of the "core government" idea, and a look at some numbers

3. Some reflections on how the quality of public/private interaction at the boundary between public and private spheres matters a lot for wellbeing

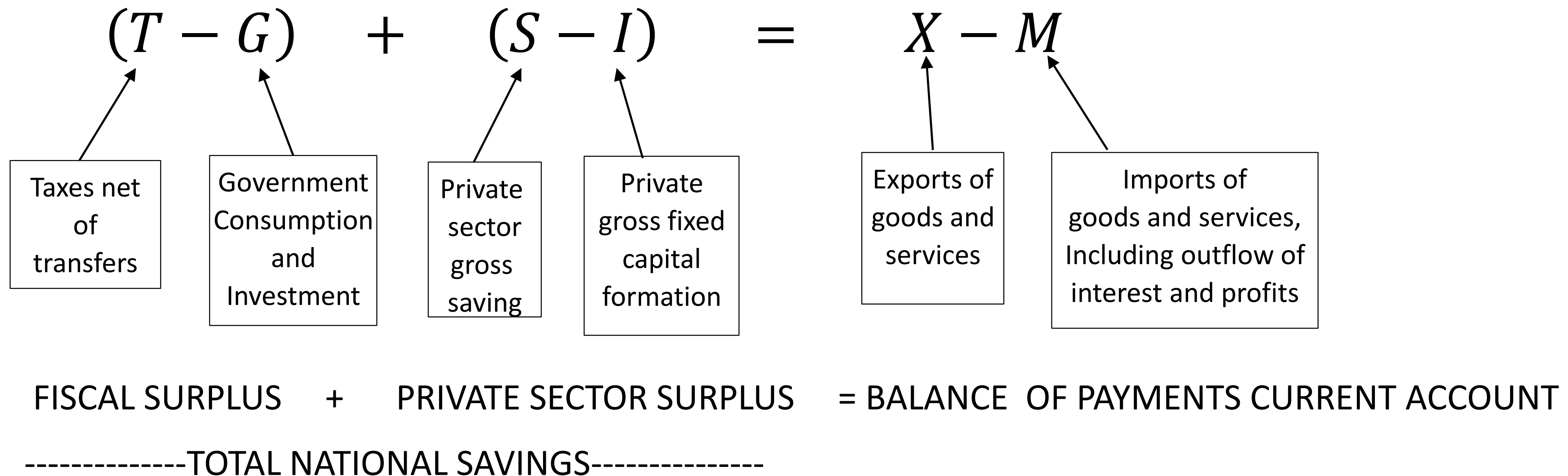
Macro balances

- Aggregate demand and supply must always balance
- Start from the textbook macro identity

$$C + I + G + X - M \equiv Y$$

Aggregate demand for output = Supply of domestic output

- Which can be dissected and rearranged to give

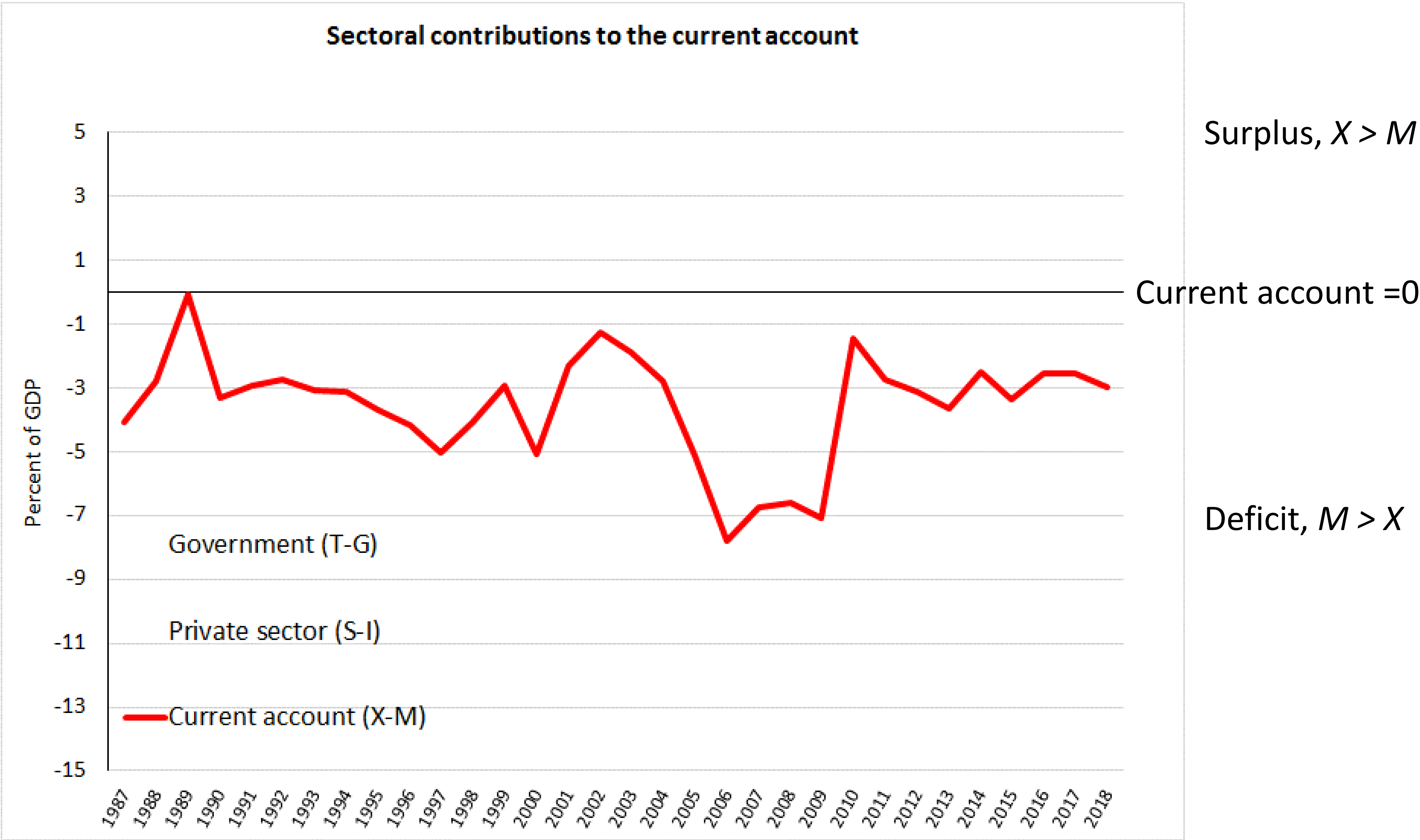


$$(T - G) \quad + \quad (S - I) \quad = \quad X - M$$

- For government to run a surplus $(T - G) > 0$, there must be a matching imbalance somewhere else:
  - Either a private-sector deficit ($S - I < 0$
  - Or a current account surplus $(X - M) > 0$
  - Or both

- Too much "budget responsibility" fiscal surplus means private sector borrowing unless the current account is in surplus

- New Zealand runs persistent current account deficits so the left-hand side of the equation is persistently negative: at least one sector must be in deficit



Sectoral contributions to the current account
Percent of GDP
5
3
1
-1
-3
-5
-7
-9
-11
-13
-15
Government (T-G)
Private sector (S-I)
Current account (X-M)
1987
1988
1989
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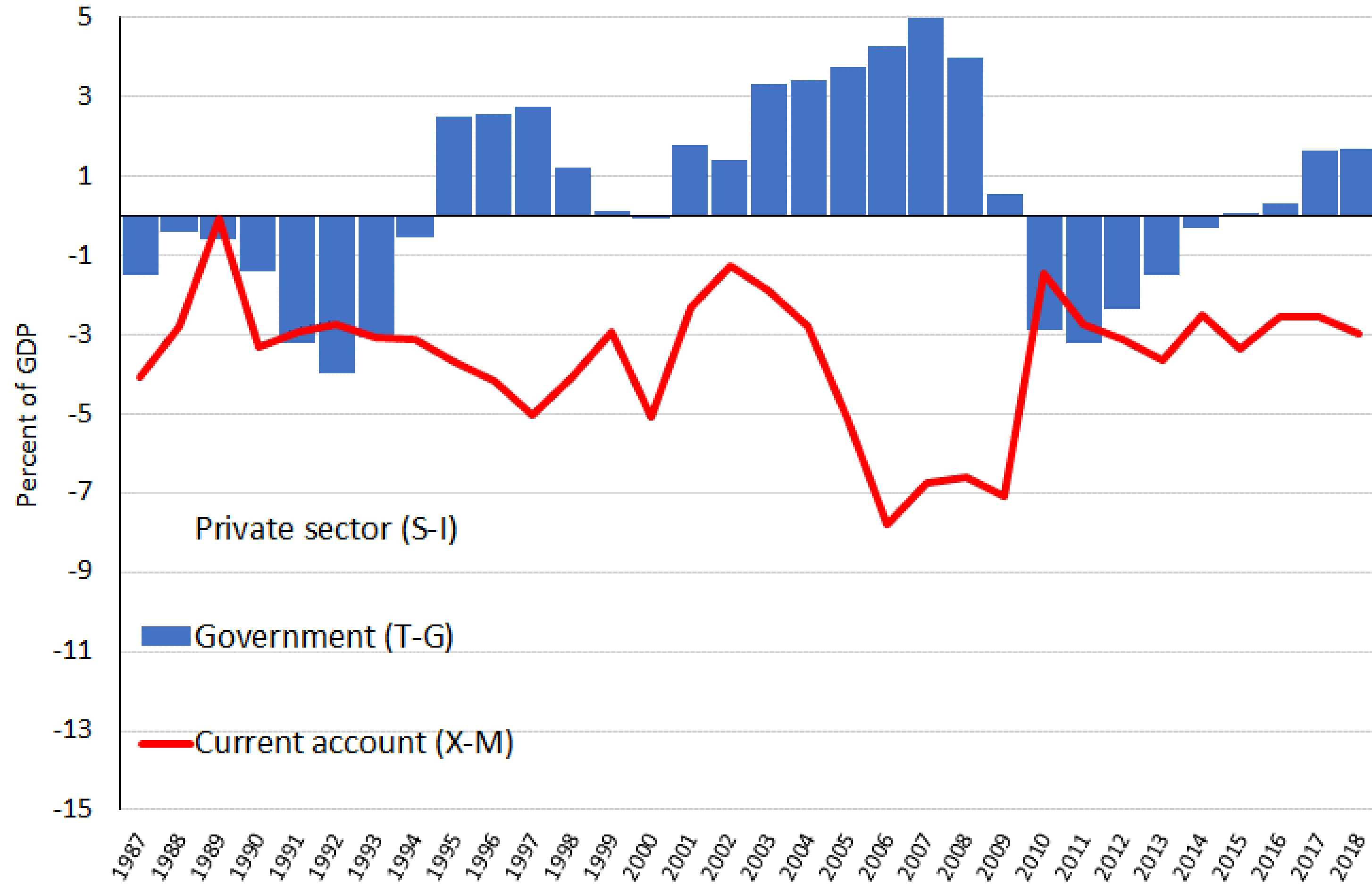
2018
Surplus, X > M
Current account =0
Deficit, M > X


Sectoral contributions to the current account
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Private sector (S-I)
Government (T-G)
Current account (X-M)
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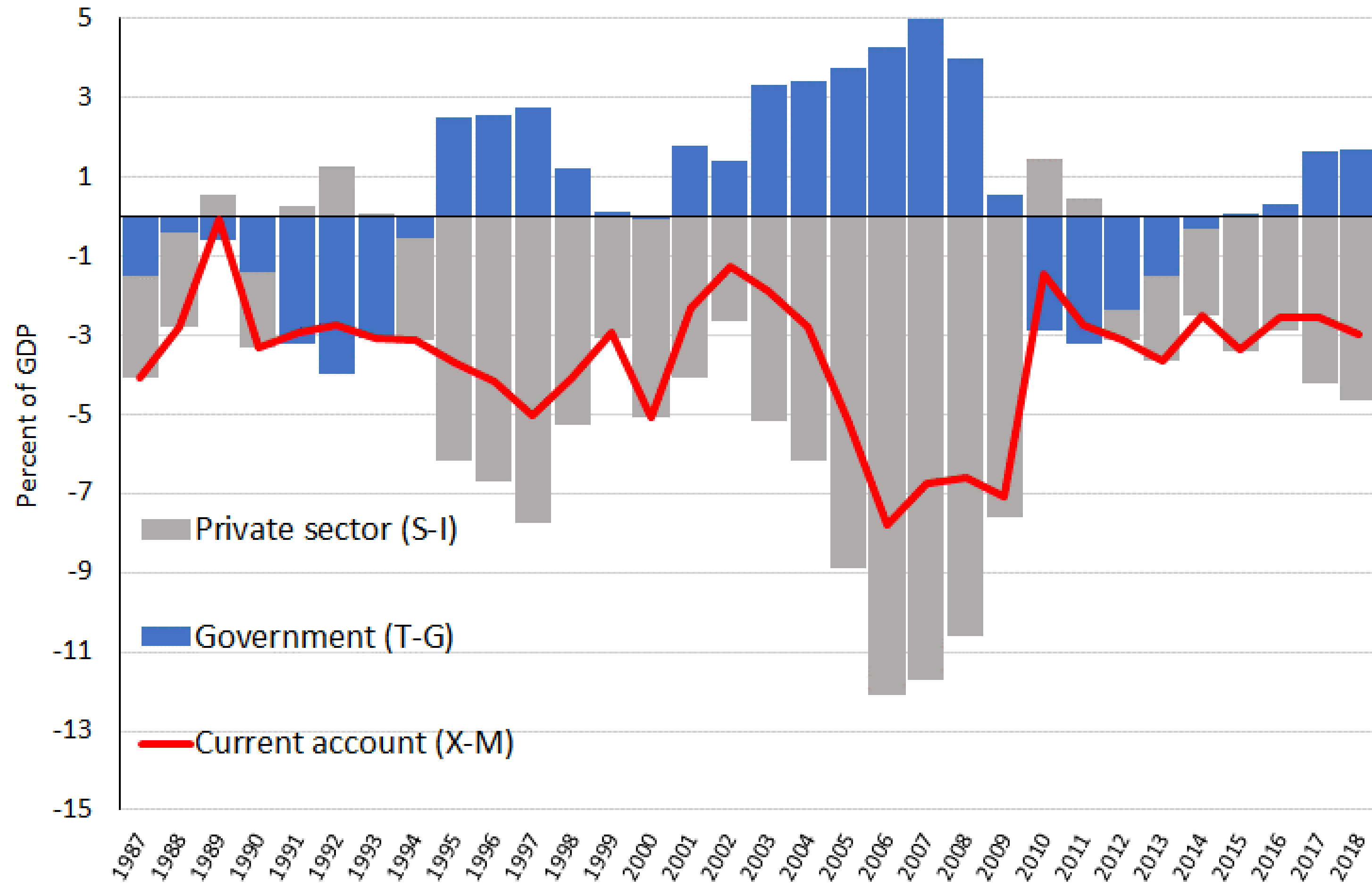

Sectoral contributions to the current account
Percent of GDP
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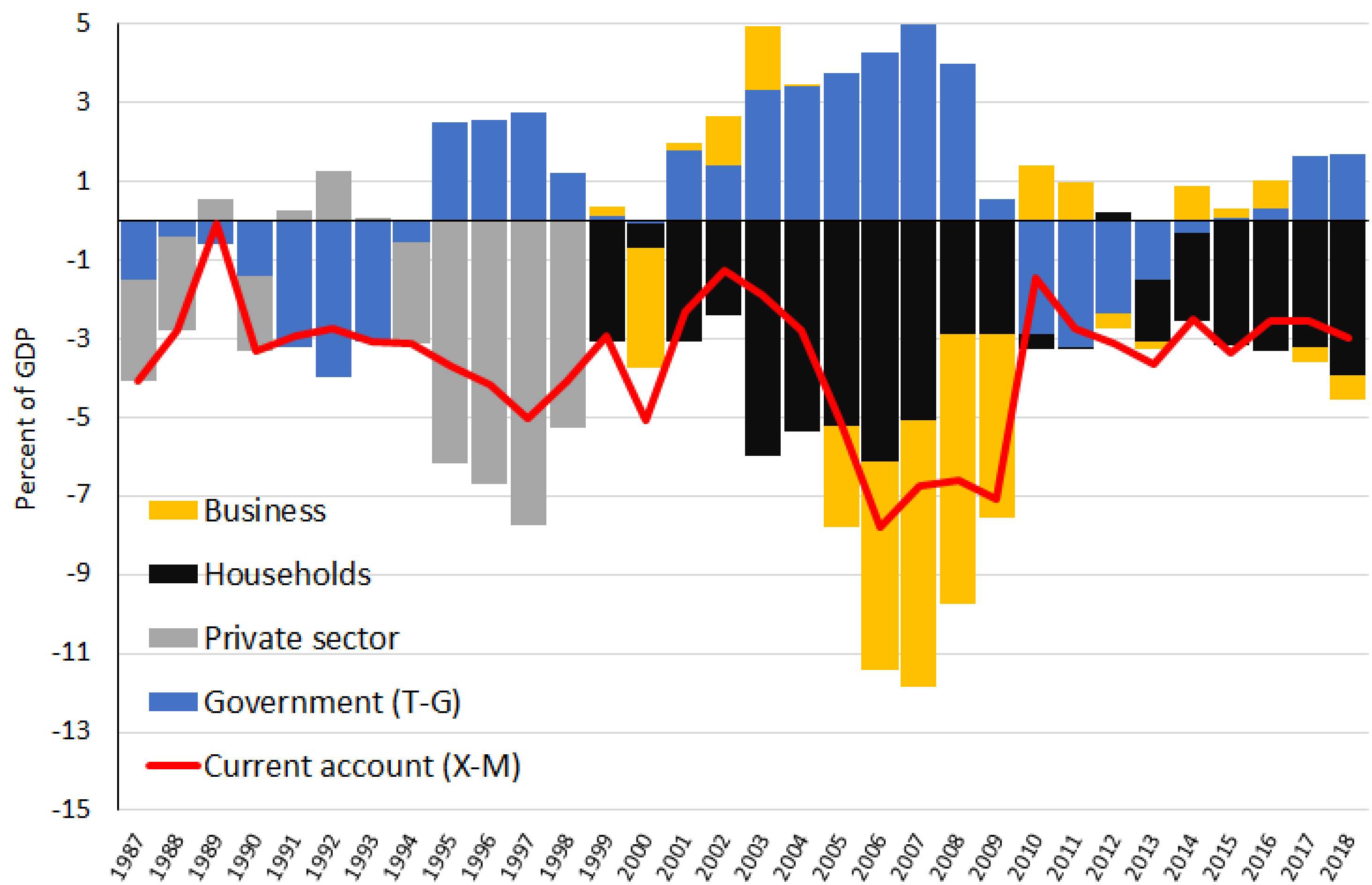
2018
Private sector (S-I)
Government (T-G)
Current account (X-M)


Sectoral contributions to the current account
Percent of GDP
5
3
1
-1
-3
-5
-7
-9
-11
-13
-15
Business
Households
Private sector
Government (T-G)
Current account (X-M)
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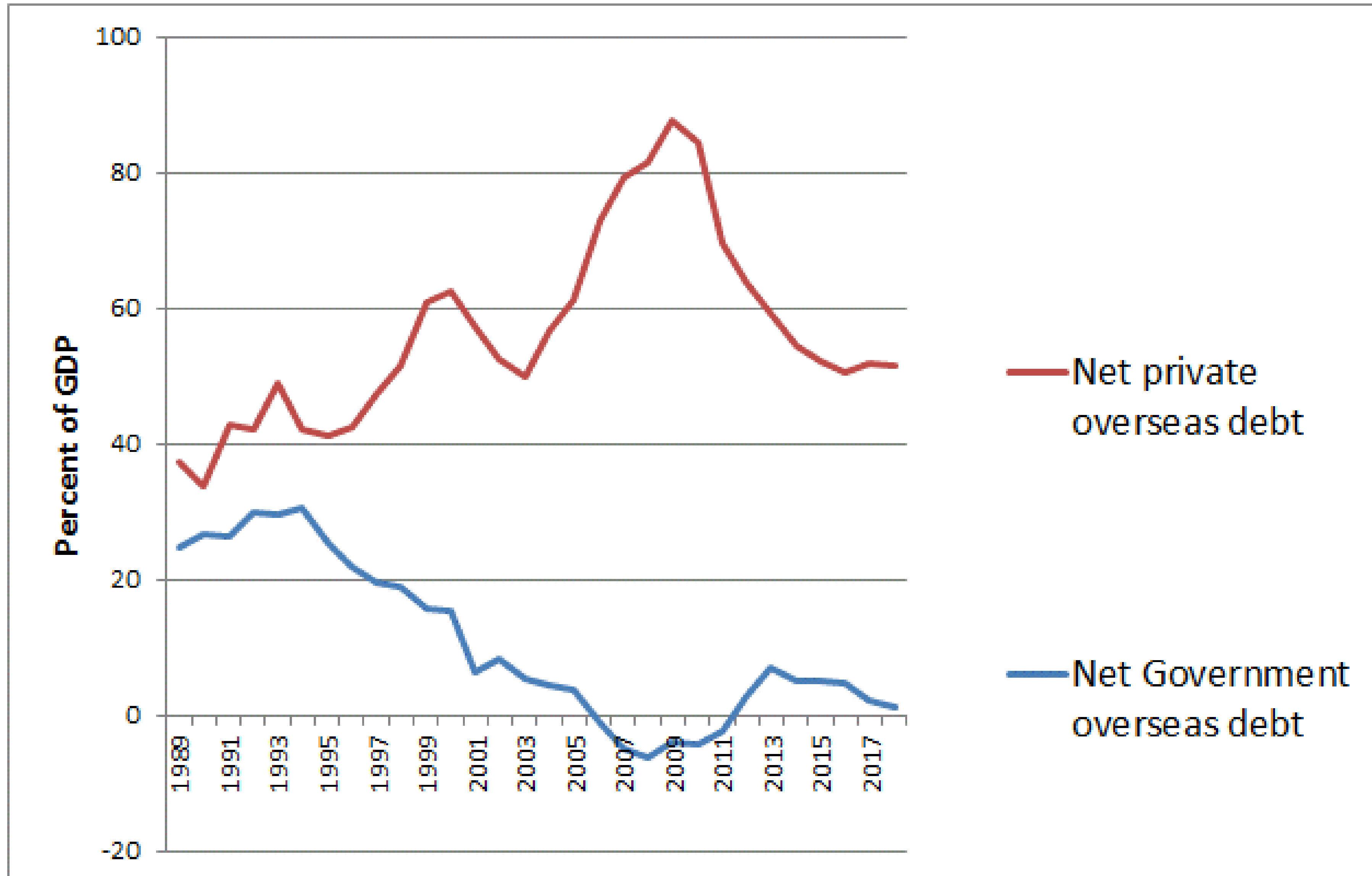
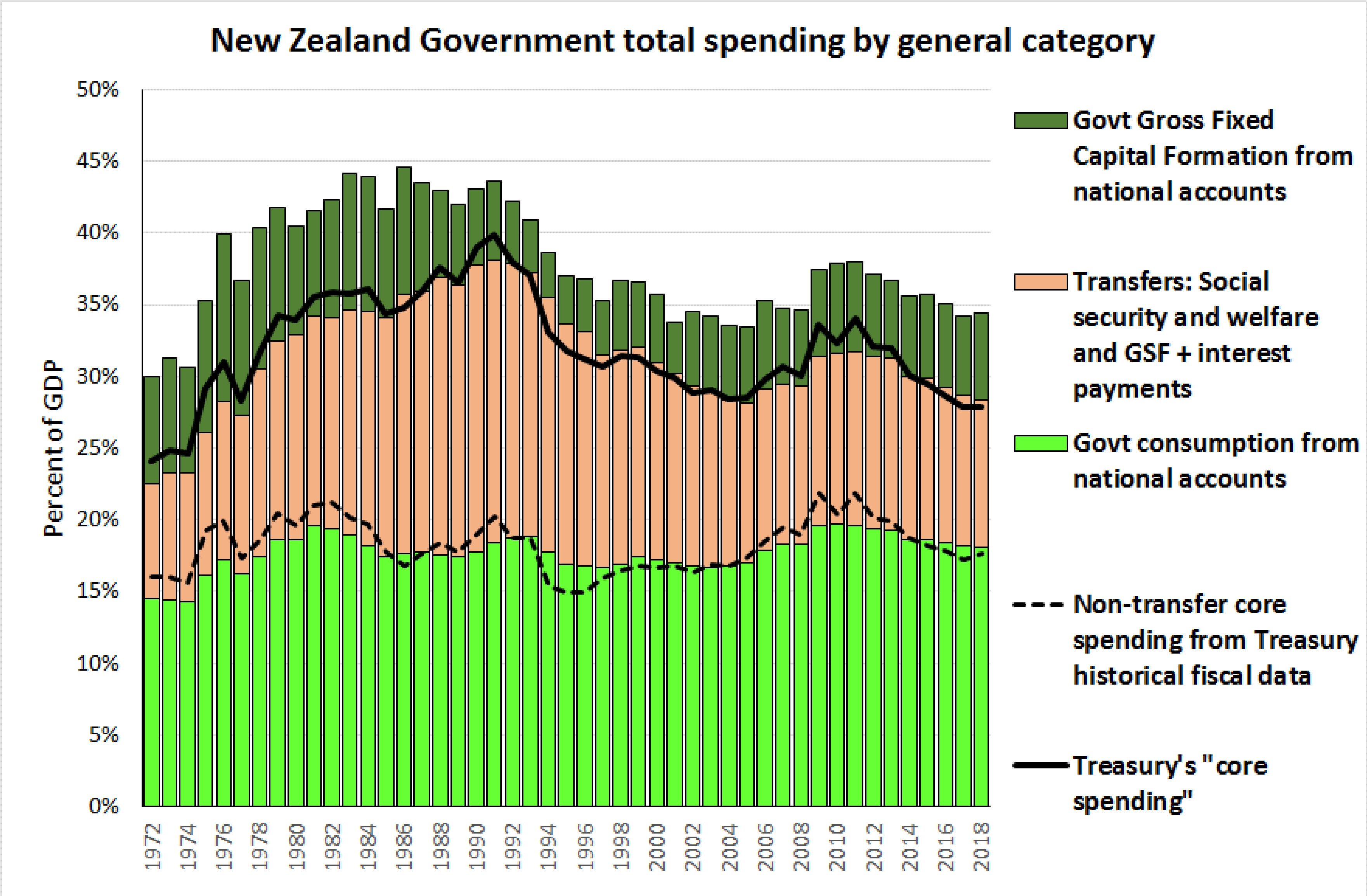
Implications for public and private external debt accumulation



Causality is obviously an issue

- So the Budget has to be designed with an eye to the macro externalities
- Fiscal policy only sometimes drives the balance of payments current account
- Achieving a fiscal surplus against an unresponsive current account forces the private sector to take on more external debt, unless the desired fiscal surplus is suppressed by feedback from the macro-economy

Second issue: how big is the state sector - 35%, 30%, or 25% of GDP?



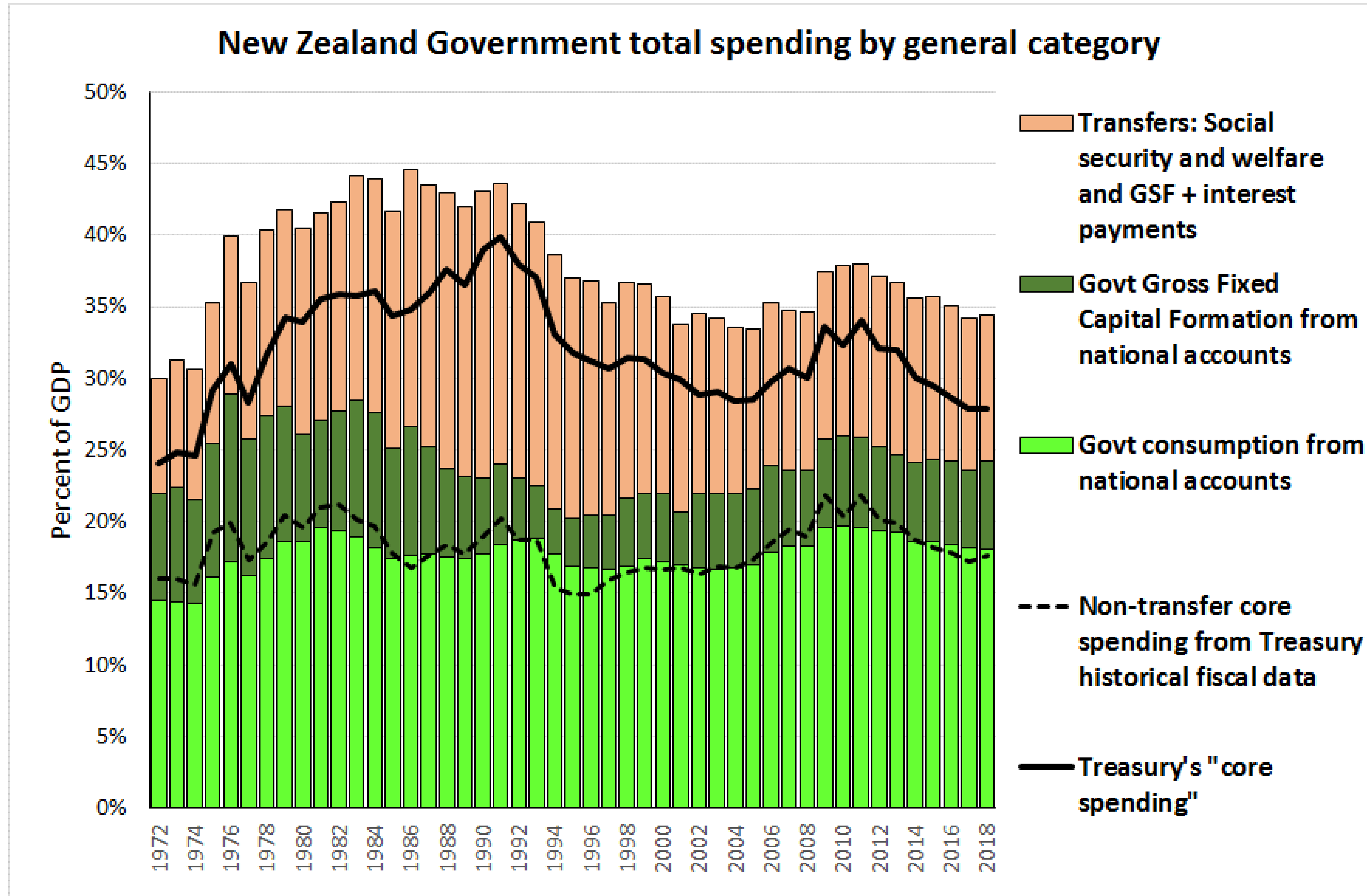
But

- It is anomalous to treat tax/transfer flows as part of “the size of the state” in the same sense as government consumption and investment
- Transfers are different from Government consumption and investment spending
- Government’s consumption and investment spending involve direct claims which draw the economy’s resources into production of goods and services to be delivered by the government to citizens (including dependents)
- In a fully employed economy, *G* (government consumption and investment <u>excluding</u> transfers) draws real resources away from private sector and/or external sector – so taxes to finance these do reduce private disposable income
- But transfers simply shift purchasing power from one part of the population to another, so the taxes required to finance <u>them</u> do not represent any withdrawal of aggregate purchasing power from the private sector
- *T* in the macroeconomic equation is taxes minus transfers – but in the financial statements transfers are not netted out from either *T* or *G*

What tax-financed transfers do and don't do

- They change the distribution of income, and hence over time the distribution of wealth
- They mitigate hardship and improve well-being in one group at the expense of others – from a wellbeing point of view this should be positive-sum, but not pareto-improving
- They shift the composition of final demand, probably towards greater demand for basic needs goods and services, and smaller demand for luxuries
- They do not increase the state's direct claim on the economy's scarce resources

So here's a rearranged version of the chart with a 25% Core:



Third issue: location and quality of the interface between public-sector and private sector spheres of activity

- Distinguish between “cost-efficiency” in getting outputs in the microeconomic neoclassical sense, and effectiveness in securing wellbeing outcomes

- Pursuit of “cost-efficiency” in an environment of austerity (disguised as “responsibility”) has produced several consequences
  - The funder-provider split and emphasis on contracting-out has violated Coase’s commonsense propositions about the scope of the firm
  - Withdrawal by the state from areas in which it has (or should have) a comparative advantage has left real needs and demands to be met by other sectors that are at a comparative disadvantage => heavy deadweight costs in terms of shoe-leather, anxiety, loss of leisure and decay of work-life balance

- Hence shadow taxation: government predates on ordinary people’s leisure time and comparative advantage, imposing serious deadweight cost burdens that are never monetised

Examples

- The 2018 census economised on public-sector employment costs by requiring everyone to respond online. Result a useless census.

- Mental health: withdrawal of institutional facilities and a pull-back on the cost of public-sector specialists did not put an end to mental health issues; it just unloaded the costs of dealing with them onto private-sector players, while failing to provide adequate backup support services.

- “What’s my number?” Instead of regulating electricity retail prices, Government requires consumers to incur costs of search, negotiation and regret in a market with asymmetric power and information

- Public works: the state has a comparative advantage in constructing large-scale infrastructure where that infrastructure is to be provided, and priced, as an essential service. There was never a convincing case for abolishing the Ministry of Works, and there is now a strong case for reinstating it

- Posting a letter has become a major mission

- Getting government forms in hard copy: the digital interface wastes huge amounts of ordinary people's time and emotional energy

- Ditto waiting on telephone call sites of departments that no longer provide street-front office services

… and of course getting information

Conclusion

1. Give more prominence in Budget documents to the macroeconomic setting – especially the big sector balances

2. Change the definition of “core Government” to something more in line with the macroeconomist’s concept

3. Put the public-private operational interface at the centre of wellbeing policy design – bring human beings back into face-to-face contact and engagement