

Balanced budget fundamentalism

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05 September 2011

Under extreme pressure from the financial markets and from Germany, member countries of the eurozone feel obliged to introduce balanced budget clauses into their constitutions. The German government argues that balanced budget constitutional clauses are necessary to avoid future government debt crises.

But is a balance budget rule a good idea? In my view, it is not. First, the rule is based on a defective diagnosis of the government debt crisis in the eurozone. With the exception of Greece, the reason countries got into this crisis has little to do with the poor management of government finances. The root cause of the debt problems in the eurozone is the unsustainable debt accumulation in the *private* sectors of many eurozone countries. From 1999 until 2007, when the financial crisis erupted, private households in the eurozone increased their debt levels from about 50% of GDP to 70%. The explosion of bank debt in the eurozone was even more spectacular, and exceeded 250% of GDP in 2007. Surprisingly, the only sector that did not experience an increase in its debt level during that period was the government sector, which saw its debt decline from 72% to 68% of GDP. Ireland and Spain, two of the countries with the severest government debt problems today, experienced the sharpest declines in their government debt ratios prior to the crisis. These are also the countries with the greatest accumulation of private debt.

After the crash of 2008 the reversal of private debt accumulation in the eurozone triggered the well-known phenomenon of debt deflation dynamics, forcing governments of the eurozone countries to allow their own debt levels to increase. This was achieved through two channels. The first consisted of governments actually taking over private debt (mostly bank debt). The second operated through the automatic stabilisers set in motion by the recession-induced decline in government revenues. As a result, the government debt-to-GDP ratios started increasing very fast *after* the eruption of the financial crisis. It could be said that this increase was necessary to save large segments of the private sector.

Surely, this increase in government debt levels has little to do with government profligacy, which should be tamed by imposing tough balanced budget rules. Spain and Ireland actually did better than balance the budget; they accumulated surpluses. Yet this did not prevent these countries from being drawn into a sovereign debt crisis. Thus, if countries adopt balanced budget rules, future government debt crises can still occur.

This leads us to the second problem concerning balanced budget rules. Nobody wants to introduce a rule that says that the government budget should be balanced every year. For

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obvious reasons: such a rule would imply that when a recession sets in and the budget deficit automatically increases, the government would be forced to raise taxes and cut spending immediately. This would reinforce the recession and create a downward economic spiral. No modern government, including a German one, would want this to happen. That is why the German balanced budget rule is formulated in terms of the 'structural' budget. This is the government budget deficit or surplus that is obtained after taking out the effect of the business cycle. Such a structural budget rule allows governments to have a deficit during a recession, provided it is compensated by surpluses during economic booms.

The problem with this rule is that it will be very difficult to implement. The reason is that economic science is not sufficiently reliable to be able to determine what the structural and cyclical components of the budget are. Ask economists today what these structural and the cyclical components of the government budget deficit are and you will probably get a very different answer from each of them. This lack of reliable knowledge makes it possible for governments to cook up the numbers. They will always find reputable economists to back up these numbers.

A final problem with the balanced budget rule is that it is based on a cynical view of what governments actually do. The rule implies that in the long run the debt-to-GDP ratio moves towards zero. The reason is that with a balanced budget rule the government cannot issue new debt (over the business cycle). Since GDP increases, the debt-to-GDP ratio must decline and ultimately go to zero.

There is no sound economic reason to back up such a rule. Governments invest in infrastructure, human capital, the environment, and in law and order. All these investments increase the productive capacity of a nation. There is no reason for governments to be prohibited from issuing debt to finance these investments. In much the same way as there is no reason to prohibit firms that invest productively to issue debt. In fact, economic theory tells us that governments that invest productively should issue debt to finance these investments. Productive investments profit present and future generations. It is therefore desirable to spread the cost of these investments over present and future generations.

What should be avoided is unsustainable debt, not debt *per se*. Belgium, Italy and Greece, for example, have unsustainably high levels of government debt. They will have to reduce these debt levels substantially. Once they have reached sustainable levels, however, there is no good economic reason to force them to guide their debt-to-GDP levels towards zero, as the balanced budget rule stipulates.

Balanced budget rules take the cynical view that all government debt is bad. This is also the view that governments are simply wasteful and do not contribute to the productivity of a nation. If one takes this view, then yes, a balanced budget rule makes sense. Such a view, however, is the expression of an economic fundamentalism that says that what governments do is bad, and what markets do is good.