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**PUBLIC POLICY**

P A R T V I

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CONSTRAINTS ON  
PUBLIC POLICY

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## CHAPTER 25

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# ECONOMIC CONSTRAINTS ON PUBLIC POLICY

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JOHN QUIGGIN

### 1. INTRODUCTION

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Economics is commonly described as “the science of allocating scarce resources.” By contrast, a popular description of politics is “the art of the possible.” Both of these descriptions refer to the same central feature of human existence: our wants generally exceed our capacity to satisfy them. However, economic and political approaches to the problem of scarcity are quite different.

In the standard mainstream economic view, the problem of allocating limited resources has a well-defined optimal solution, for any given initial allocation of property rights. Moreover, this solution can be achieved, or at least approximated, by allowing individuals to trade freely in markets, perhaps with the assistance of governments to correct a variety of market “failures” or “imperfections.”

The political view, and particularly the “pragmatic” view associated with the characterization of politics as the art of the possible, is rather different. The gap between wants and resources is expressed in the form of demands on governments. The political problem is that of achieving “bargained consensus,” at least among those groups with a capacity to obstruct or veto an agreement. The art of the

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politician consists partly in leading parties from initially disparate positions to sustainable compromise, and partly in finding policy innovations that permit the achievement of seemingly irreconcilable goals.

In the practice of this art, the ambiguity of the term “possible” is crucial. On the one hand, it refers to limitations in a manner similar to that of the economist. There is a bounded set of possibilities, and the problem is to choose between them. On the other hand, there is a deep-seated notion of limitless possibility, that if we only set our minds to it, we can achieve anything.

One way in which the conflict between the two views may be usefully examined is by considering economic constraints on public policy. Constraints play a central role in economic thought: the problem of how best to allocate scarce resources is commonly represented, in mathematical terms, as one of maximizing an objective function subject to one or more resource constraints. This approach is not always congenial to political practitioners, who frequently suggest that alleged constraints are being used to promote the adoption of particular policies on the grounds that “there is no alternative.”

In this chapter, a variety of perspectives on the role of economic constraints are considered. First, the relationship between economic constraints and accounting identities, such as those derived from government budgets and national accounts, is examined. The relationship between budget balance constraints and external balance constraints is considered with reference to notions of “crowding out” and “twin deficits.” The idea that globalization has tightened the constraints on governments is critically assessed and found to be largely baseless. Second, the dual relationship between constraints and trade-offs is considered. The presence of a constraint implies a trade-off and vice versa. This relationship provides the basis for a consideration of how public policy can respond to constraints and trade-offs.

## 2. IDENTITIES AND CONSTRAINTS

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An important set of constraints on public policy arise from a range of economic and accounting identities.

### 2.1 The Budget Balance Constraint

To take a simple example, a government’s budget balance is the difference between revenue (mainly from taxation) and public expenditure, being a surplus if this is positive, and a deficit if (as is more common) this is negative.

Surveys of public opinion commonly show that majorities of respondents support increases in public expenditure, reductions in taxation, and improvements in the

budget balance.<sup>1</sup> Politicians therefore have incentives to support all three, but they are not mutually consistent.

A variety of accounting devices, such as the treatment of the proceeds of asset sales as if they were current income, may be and have been used to provide the appearance of stable budget balance even while expenditure is rising and revenue is declining. Such expedients are inevitably doomed to failure in the long run.

In the long term, the budget balance constraint is simpler: appropriately measured, government consumption and payments of benefits must equal government income. Borrowing allows higher consumption in the present at the expense of lower consumption or higher taxes in the future, but the requirement for long-run balance cannot be avoided.

A number of issues arise here. The first is that, given a positive real rate of interest, a given amount of consumption or income now can be traded for a larger amount in the future. This means that, to compare streams of consumption and income, it is necessary to convert them to a present value using standard discounting procedures.

The second issue, which follows logically from the first, is that in evaluating budget balances, it is necessary to focus on current consumption and current income, excluding capital transactions and the associated flows of interest payments, of which the most important are interest payments on public debt. These payments are taken into account in present value calculations, and treating them as part of current debt would lead to double counting.

A third, and much trickier issue concerns the treatment of risk. In general, a risky stream of income is less valuable than a riskless stream with the same expected value, and this fact needs to be taken into account in evaluating budget constraints. This problem raises complexities that are beyond the scope of this chapter, but are addressed in Quiggin (2004).

Next, it is important to consider ways in which it might seem possible to avoid the long-run balanced budget constraint. Historically, the most popular strategy has been the use of the government's capacity to create money by resort to the printing press (or in the days of metallic money, through debasement of coinage). Although the relationship is neither instant nor automatic, this method of finance invariably leads to inflation.<sup>2</sup> Inflation reduces the value of existing holdings of money, and also of outstanding obligations such as government bonds, and is therefore best seen as a tax on holders of such assets. Over the long run, benefits from taxing bondholders through inflation are cancelled out by compensating increases in nominal interest rates, so the only real benefit is that derived directly from the issuance of money. The resulting revenue is called seignorage.

<sup>1</sup> This does not necessarily mean that individual respondents are acting inconsistently. Suppose for example, that one third of respondents favour lower taxes and improved budget balance, one third favour higher expenditure and improved budget balance, and one third favour lower taxes and higher public expenditure. Then there is a majority in favour of all three proposals, even though no individual supports all three.

<sup>2</sup> In fact, some economists use the term "inflation" to refer to expansion of the monetary base, rather than to the ensuing increase in the general price level. This is the interpretation that fits most naturally with the ordinary meaning of the term.

If inflation is regarded as a tax, it is evident that the availability of this option does not lead to any relaxation of the balanced budget constraint. Considered as a source of revenue, inflation taxes may be compared with other taxes to determine what rate of inflation is socially optimal. The general consensus of economic opinion at present is that modest, but positive rates of inflation, of around 1 to 2 per cent annually, are optimal. The resulting seignorage amounts to around 0.5 per cent of GDP for the United States (much of this associated with offshore holdings of dollars) and less for other developed countries. This is small in relation to other sources of revenue such as income and sales taxes and can therefore be disregarded for most purposes.

A second strategy aimed at avoiding the balanced budget constraint is the sale of assets, most notably through the privatization of government business enterprises. This expedient was particularly popular in the 1980s and 1990s. Although there has been a variety of arguments put forward in support of privatization, one of the most consistent themes in the case for privatization has been the claim that the sale of public assets can reduce government debt without the need for higher taxes or lower public spending.

This claim is fallacious. Selling an income-earning asset such as a government business enterprise means forgoing the stream of earnings generated by that asset. Selling a service-generating asset such as a publicly owned building means that it is necessary to pay for, or do without, the services that the asset previously generated. If the asset has the same value in private and public ownership, the revenue realized by selling it will be equal to the present value of the income and services generated by the asset. In this case, the budget balance constraint is unaffected by asset sales. This fact is recognized in the accrual accounting systems now in use in many jurisdictions. However, under the cash accounting systems used until the 1990s, the proceeds of asset sales were treated as if they were current income.

Asset sales produce a net benefit if the proceeds from the sale are greater than the value of the asset in continued public ownership. It makes sense, therefore, for governments to manage their assets actively, and dispose of unused assets. A common example is the sale of land acquired for some public purpose that is no longer relevant.

On the other hand, if assets are sold for less than their value in continued public ownership, a net loss results. Most privatizations undertaken in developed countries have produced a net loss of this kind. The privatization of British Telecom set the pattern. Half of this enterprise was sold at a price equivalent to only two years' earnings. Subsequent privatizations have produced smaller losses in most cases, but the general pattern of losses has not changed. As a result, some advocates of privatization have revised their views (Nellis 1999).

The British experience is instructive. The Thatcher government sold assets and used the proceeds to cut taxes substantially, while making only modest cuts in aggregate public expenditure. Under the cash accounting system the asset sales allowed the government to record a surplus. By the early 1990s, however, with the tax cuts still in place and with no more assets left to sell, the surpluses turned into

large deficits, exacerbated by the economic downturn beginning in 1990. By 1993–4, the deficit approached nearly 8 per cent of GDP. The resulting increase in debt implied a requirement for higher taxes and lower public expenditure to cover interest payments.

If in an appropriate sense, budgets must balance in the long run, it is natural to consider a requirement that governments should maintain balanced budgets at all times, at least on an annual basis. Such requirements have been adopted by many governments, either as a constitutional or legislative constraint, or as a matter of policy. There are, however, strong arguments against a requirement for annual balanced budgets.

In the absence of specific policy changes, tax revenue will decline during recessions and public expenditure (for example on unemployment benefits) will rise. The shift in the budget balance partly offsets the decline in national income during a recession, helping to reduce the impact on aggregate (public and private) consumption. This automatic stabilizing effect reduces the severity of recessions.

In addition to these direct effects, Keynesian models of the economy imply that there is a second-round effect arising from the stimulus to private demand generated by public sector payments. Hence, Keynesians usually favour additional discretionary fiscal policies to stimulate demand during recessions.

Although highly successful in the decades immediately following the Second World War, Keynesian fiscal policies have had mixed success since then. Critics of Keynesian economics generally prefer rule-based approaches in which tax rates and policy programs are fixed so as to maintain budget balance over the course of the economic cycle. Even without discretionary intervention, however, a rule-based approach implies that the budget will not be balanced on an annual basis.

The most appropriate interpretation of this constraint is a version of what has been referred to as the “golden rule,” namely that, over the course of the economic cycle the net worth of the public sector, expressed as a proportion of GDP, should remain constant.

## 2.2 The External Balance Constraint

The second major constraint with which policy makers have to deal relates to external balance, that is, to international flows of goods, services, and capital. National accounts incorporate identities relating to external balance, and these constraints correspond to constraints on economic policy.

The most important identity is that the balance of payments on current account (the difference between the values of exports and imports of goods and services plus the difference between outgoing and incoming flows of income payments) is equal and opposite to the balance of the capital account (the difference between outgoing and incoming flows of capital in the form of debt and equity investment). So, for



example, a country like the United States, which consistently has a deficit on the current account, must *by definition* have a surplus on the capital account. It follows that the simplistic assumption that deficits are invariably bad and surpluses invariably good is self-contradictory; each surplus has its corresponding deficit.<sup>3</sup>

Just as with government budgets, the accounting identities imply a long-run constraint that, appropriately measured, imports and exports must balance. Although the long-term external balance constraint cannot be avoided, the force with which it bears on national governments varies greatly depending on the settings of policy.

### 2.3 The Twin Deficits and Crowding Out

The budget balance and the external balance, combine with the consumption and investment of the private sector to form the national income identity:

$$\text{Income} = \text{Consumption} + \text{Investment} + \text{Govt spending} + \text{Exports} - \text{Imports}$$

Again, it is important to emphasize that this is an identity, true by virtue of the definitions of the terms, and not because of any particular economic theory. This identity can be rearranged in various ways. The most useful involves taking taxation revenue into account as a transfer from households to governments. Rearranging, it is then possible to show that the government budget deficit must be equal to the sum of Imports – Exports (the trade deficit) and Private Saving (after-tax income less consumption) – Investment. When a government increases spending or cuts taxes, leading to a higher budget deficit, one or other of these must change as well since the accounts must balance.

The “twin deficits” hypothesis is that the adjustment will take the form of more borrowing from abroad, that is, an increase in the capital account surplus and, therefore, the current account deficit. Hence the budget deficit and the current account deficit are “twins.” This hypothesis seems to fit the data on some occasions, such as Australia and the United States in the 1980s, but there are some obvious exceptions. In the late 1990s, the US budget went from deficit to surplus, but the current account kept on increasing.

An alternative view is that balances of trade in goods and services, and on the current account, are determined mainly by factors specific to the traded goods sector. If this is the case, then increases in the government budget deficit must be matched, in equilibrium, by increases in private saving. We can write:

$$\text{Saving} = \text{Income} - \text{Tax} - \text{Consumption} - \text{Investment}$$

If taxes are assumed to be set by government, an increase in savings can be realized by changes in any of the other three variables. Views about the desirability or otherwise of budget deficits depend in part on which variable is seen as likely to adjust.

<sup>3</sup> Because the measures of international flows are imperfect, the accounts do not, in general, balance automatically and must be reconciled by the inclusion of a “statistical discrepancy.”

The most pessimistic view, called “crowding out,” is that investment will decline as private savings are used to fund the budget deficit.<sup>4</sup> The neutral position, called Ricardian equivalence, is that consumption will adjust. In this story, people realize that the budget deficit will imply higher taxes in future, and increase saving now. Few economists find this story plausible, although it is consistent with an extreme version of the rationality postulate commonly adopted by economists. The optimistic position is that income will increase, partly offsetting the original increase in the budget deficit as tax revenue rises and also allowing for higher private savings.

There are two reasons why the optimistic position may be justified. The first is derived from Keynesian macroeconomics and the other from “supply-side” microeconomic theories.

The Keynesian argument for deficits, discussed above, assumes that there are lots of unemployed workers, idle factories, and so on. The extra demand produced by tax cuts or government spending is met by hiring more workers and reopening factories, which in turn stimulates “multiplier” effects. In a very simplistic model, sometimes referred to as the “pump-priming” model, the growth is sufficient to wipe out the original increase in the budget deficit.

Most economists are Keynesian in the short run, but believe some mixture of crowding out and twin deficit models applies in the long run. As already discussed, this suggests the ideal policy called the “golden rule,” namely, running deficits during recessions and surpluses during booms so as to achieve budget balance over the course of the cycle.

The “supply-side” argument based on the (in)famous Laffer curve applies only to cuts in taxes. It’s claimed that the extra incentives provided by the tax cuts will stimulate more work effort, higher investment, and so on, thereby raising income and in the extreme case, wiping out the original increase in the budget deficit, as in the “pump-priming” story. Few serious economists accept this strong claim. Evidence on whether there is any relationship between tax rates and growth in national income is mixed, but there is a broad consensus that it is unwise to rely on incentive effects when projecting the likely consequences of tax cuts.

## 2.4 Globalization and Constraints on Public Policy

It is commonly supposed that “globalization” has tightened the constraints on public policy, and particularly on economic policy. This idea has two parts. The first is that globalization and, in particular, the massive growth in international flows of capital observed over the past three decades is the inevitable outcome of technological change, and particularly of the striking innovations in computing and telecommunications that have taken place in recent years.

<sup>4</sup> As the argument above shows, the twin deficits hypothesis and the crowding out hypothesis are logically contradictory. Nevertheless some critics of budget deficits have pushed both theories, and some have managed to believe both simultaneously.

However, recent improvements in communications are merely a continuation of a long-standing trend. For most of the twentieth century, the cost of telecommunications services has declined at a real rate of 4 to 5 per cent per year. For long-distance services the decline has been even more rapid—around 10 per cent per year. Over a period of 100 years, the compound effect yields a reduction in costs by a factor of 1 million or more.

As far as long-term financial transactions are concerned, however, the innovations of the twentieth century are not particularly important. An order to buy or sell assets worth billions of dollars can be transmitted just as effectively in a fifteen-word telegram as in a fifteen-minute telephone conversation, even though the bandwidth requirements differ by a factor of 1 million. Instantaneous communications within and between developed countries have been available since the nineteenth century.

Computers and telecommunications have permitted an increase in the complexity of financial transactions and in the volume of short-term capital flows. The increase in the ratio of the volume of financial transactions to the volume of real transactions has been widely noted with respect to international markets. It is important to observe, however, that a similarly massive increase in financial “churning” has taken place in domestic financial markets, such as stock markets.

Communications technology has been improving steadily for the last 150 years. International capital flows have shown nothing like the same steady growth. At least in relation to long-term capital flows, global capital markets were about as integrated in the late nineteenth century as in the late twentieth. Capital markets were radically disrupted by war and depression in the first half of the twentieth century. The Bretton Woods system that prevailed from 1945 to the early 1970s involved tight restrictions on capital flows, which were seen as disruptive and a threat to macroeconomic policies aimed at maintaining full employment.

It was only with the breakdown of the Bretton Woods system and the associated Keynesian macroeconomic policies that barriers to international capital flows were removed, and the massive growth of the late twentieth century began. While developments in capital markets, such as the growth of the offshore “eurodollar” market, helped to undermine the Bretton Woods system, the critical problem was the failure of domestic macroeconomic policies to respond adequately to “stagflation,” the combination of high unemployment and high inflation.

The idea of globalization as a constraint on policy options has been popularized by Friedman’s (1999) colourful metaphor of the “Golden Straitjacket.” To fit into the Golden Straitjacket, a country must adopt the following (rather redundantly expressed) golden rules:

- making the private sector the primary engine of its economic growth;
- maintaining a low rate of inflation and price stability;
- shrinking the size of its state bureaucracy;
- maintaining as close to a balanced budget as possible, if not a surplus;
- eliminating and lowering tariffs;

- getting rid of quotas and domestic monopolies;
- increasing exports;
- privatizing state-owned industries and utilities;
- deregulating capital markets and the domestic economy;
- opening banking and telecommunications to private ownership and competition; and
- allowing citizens to choose from an array of competing pension options.

This set of rules has also been referred to as the “Washington Consensus.” This term, coined by Williamson (1990), refers to the advocacy of these policies by the World Bank, International Monetary Fund, and US Treasury, all of which are located in Washington, DC. The policies formed the basis of the conditions imposed on developing countries seeking assistance in dealing with the global debt crisis of the 1980s. The successful resolution of this crisis (at least in most middle-income developing countries) helped to create the consensus described by Williamson, which was particularly strong in the early 1990s.

In many accounts the question of whether the policies of the Washington Consensus are actually beneficial is, strictly speaking, irrelevant, since there is no alternative option. This is the point of the “straitjacket” part of Friedman’s metaphor. Like other proponents of globalization, Friedman argues that governments must adopt the policy agenda of the Washington Consensus or face the wrath of the “Electronic Herd” of global financial traders. The only alternative is to create a closed society like that of North Korea.

There is little evidence to support Friedman’s claims. It is true that policies of the kind listed above have been widely adopted in the past twenty-five years, but this is more a reflection of changing ideas than of the constraints imposed by global financial markets. Britain and the United States implemented much of the policy agenda described above in the 1980s, under the Thatcher government and Reagan. European governments have been much slower to follow suit. That has not prevented foreign exchange markets from bidding the euro up to unprecedentedly high levels against the US dollar.

Moreover, contrary to what might be expected from Friedman’s arguments, the correlation between exposure to global trade and the ratio of government expenditure to GDP is positive, not negative. European countries have high ratios of trade to national product, and large government sectors. The United States and Japan have relatively small governments and relatively small exposure to trade. This may be coincidence or it may reflect a demand for government intervention to compensate for exposure to external shocks. Either way, it is inconsistent with the idea that globalization necessitates small government.

The actual relationship is more complex and interesting. In macroeconomic terms, the choices available to governments can be described in terms of the “impossible trinity.” A government cannot simultaneously pursue an independent macroeconomic policy, maintain a fixed exchange rate, and allow free international capital movements. The analysis of the problem was first undertaken by Mundell (1963), though the origins of the phrase “impossible trinity” remain obscure.