Fiscal Policy and Growth

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The households have gone crazy, they have decided to give less food to their children, to restrict their essential expenses to a minimum, to buy less clothes and not to pay the school fees and tuition for their children, all of this with the sole objective of saving money. Some households save their money in the financial system, but most accumulate it in their houses, under their mattress. The madness also touches investors, their animal spirits have disappeared and they have reduced their investments, because, strangely, they no longer like to obtain earnings. The bankers, on the other hand, no longer lend money; they maintain the deposits of their clients in vaults and prefer to lose interest payments instead of lending money and increasing profits.

This strange behavior has generated a strong economic recession causing companies to close down and tossing workers on the street. This is the Keynesian explanation of a crisis. The cause is the irrational behavior of economic agents. In this context, the government should intervene to save the population that seems resolved to commit economic suicide. The government has to increase its expenditures to compensate for the fall in private spending. Where will the government obtain the money to save the economy? The government does not have any other alternative than to confiscate the resources that the private sector maintains sleeping; then, the government will build pyramids and make blood transfusions to the dead (e.g. business hospitals). This will reactivate the economy and prosperity will arrive to all households.

The previous explanation of a crisis and its possible solution is certainly attractive for an audience convinced that economic freedom is the cause of all our problems. Regrettably, my Keynesian colleagues have confused the cause and the effect of the recession. Paraphrasing Karl Marx, we could say that their economic analysis is

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inverted, up-side-down, we just need to turn it around, put it on its foot, and soon we will discover a rational seed under the mystic clothes.

The recession described above has its cause in the government's exaggerated expense that elevates the fiscal deficit to untenable levels. This phenomenon, accentuated by their mistaken intervention in the economy – more taxes – generates high uncertainty in all economic agents, because they do not know which other problems the government might cause. The households reduce their purchases, not because they want to reduce their consumption or want to save, but simply because they do not know if tomorrow they will maintain their employment and, in the face of an eventual possibility of being without revenues, they accumulate some extra money. Capitalists will not invest their resources because they do not know whether they will be able to recover their investments in the future or the government will confiscate their resources to cover the fiscal deficit. Bankers prefer not to lend the money they maintain of their vaults because they do not know if they will be able to recover it. In sum, the cause of the recession is the excessive intervention of the State in the economy and one of its first effects is the contraction of credit, the reduction of consumption expenses of the households and the disappearance of those "animal spirits" that make capitalists invest.

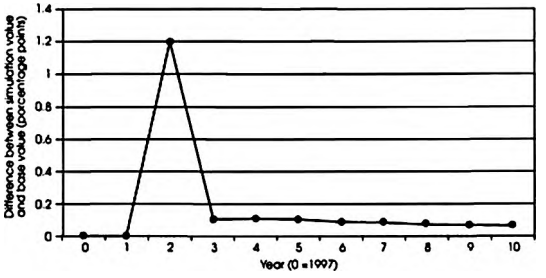
The results of an increase in public spending, to compensate the fall in the demand of the private sector, have been simulated through a Computable General Equilibrium Model of the Bolivian economy developed at IISEC. The model was developed using the structure of the Bolivian economy in 1997. To establish the baseline scenario for the next decade, various assumptions were imposed (See Mercado et al (2003) and Andersen & Evia (2003)). Using these assumptions and maintaining the structure and characteristics of the economy in 1997, the model predicts an average real rate of growth of 2.5 % per year during the 10 year forecast period.

The experiment consists of a one-time increase in public expenditure by an additional 10% in year 2 (on top of the 2.5% normal annual increase assumed in the base scenario), and subsequently returning to the historical rate of increase in public expenditures (2.5%) observed over the recent past. This corresponds to an additional outlay of approximately US$ 100 million every year in comparison with the data of the base scenario, and thus represents a permanent increase in the size of the government. It also brings about a permanent increase in the public deficit as a percentage of GDP.

of approximately 1.7 percent annually. The goal of this simulation is to determine whether growth can be permanently increased through an expansionary fiscal policy, given the composition and characteristics of the Bolivian economy.

Figure 1 shows that this permanent increase in the level of public spending generates only a temporary increase in the rate of growth of real GDP. In the year of the expansion, the rate of GDP growth is 1.2 percent higher than in the base scenario, but just one year later, the rate of growth returns to its natural level. As the level of public spending is much higher in the expansionary fiscal policy case than that of the base scenario and as the government carries a larger fiscal deficit, the conclusion is that expansionary fiscal policy in Bolivia is not effective in raising the rate of economic growth in the medium or long term.

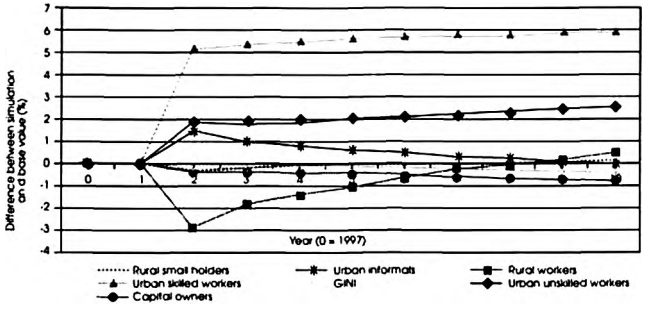
Figure 1: Real GDP Growth Rate



Source: IISEC's Computable General Equilibrium Model

The change in the composition of production that is generated by the increase in public spending also causes a modification in the distribution of household incomes. Figure 2 shows that skilled people in urban areas gain much more than the other groups. Those that lose most are rural workers and capitalists. As skilled workers are among the richest people in Bolivia already, this would tend to cause a deterioration in the income distribution. Capitalists are even richer, but since they comprise a relatively small group in Bolivia, its impact on the general income distribution is minor. The biggest and poorest group, the rural small-holders, are virtually unaffected by the dramatic increase in government spending. This means that more public spending would tend to widen the already huge gap in incomes between rural and urban households.

Figure 2



Source CGE simulation made by IISEC

In conclusion The permanent increase in public spending causes a very transitory increase in the rate of GDP growth of about 1.2 percentage points, but it comes accompanied by a permanent cost in terms of a bigger public deficit of 1 7% every year Higher public spending also tends mainly to favor the rich people

In the same line, Mercado (2002) estimated the determinants of Total Factor Productivity (TFP) for 1980-2002 and concluded that in all cases reductions in the participation of government expenditures to GDP are positively associated with his measures of TFP Other simulations of the effects of active monetary and fiscal policies, using IISEC's CGE model, can be reviewed in Mercado et al (2003) and Andersen & Evia (2003)

All the economic growth models, independently of their specificities, lead to the conclusion that economic growth will only be possible if investment expending increases, they also coincide in the fact that the financing of this investment must be sustained by domestic or foreign savings. Domestic savings are the sum of private savings and public savings, then, if the public sector presents a deficit, that is to say negative savings, this will necessarily reduce domestic savings, and most likely also foreign savings, translating into smaller global saving, less investment, and lower long run growth rates The belief or, better said, the myth, that increased public spending is expansive does not have a solid theoretical background and neither has it been supported by empirical data On the contrary, the empirical information proves it to be false