Public Finance

From the Income Pie to the Spending Pie

The critical role of the finance system is to perform the 'negotiation' that establishes the Spending Pie formulation of the GDP pie. The centrestone of the finance system is the banking system. Thus, it is about the establishment of (financial) surpluses and (financial) deficits, in full awareness that, globally, the sum of all surpluses must be equal to the sum of all deficits.

A world without surpluses and deficits would be a world in which all income entitlements were 'spent' on 'enjoyments', meaning that the entire pie is consumed in proportion to the income entitlements granted by the rules of income distribution and redistribution. In such a world, saving and borrowing are not options, although the gifting of enjoyments is possible.

A financial surplus represents a person's decision (economists might call it a 'plan' or an 'intention') – or a contractual requirement – to allow someone else to access part of their income portion. In popular language, a person's surplus is called saving, lending, or debt repayment. Saving may take the form of lending, which includes placing or holding income as 'money in the bank', and buying newly issued shares (equities) in a firm.

A financial deficit represents a person's decision to 'withdraw money' from the bank, and then to use that money to buy enjoyments. Or a person may call in a loan made to another person. Or a person might borrow money from the bank or some other financial institution.

Or it may take the form of purchasing an existing 'asset'; this is the 'secondary market'. In this case, the purchase is essentially a transferred income, whether or not the item acquired is a 'physical thing' or a 'promise' or a 'title'. A surplus takes place if the seller of the asset does any of the abovementioned things.

In mercantilist thinking, saving is essentially hoarding, so saving money (ie wealth) is essentially hoarding money, and that – at a time chosen by the hoarder – money will transform itself into whatever enjoyment is wanted; much as a chrysalis transforms into a butterfly, or as stem cells transform into whatever kind of cells are required.

The reality that saved income is deferred enjoyment; a *claim* on future enjoyment. The amount of future enjoyment a certain amount of savings can procure is unknown, and may be zero; it all depends on the health of the market economy in the year that claim on enjoyment is exercised (spent). Savings represent claims on wealth, promises of enjoyable wealth; they are not in themselves wealth.

The opportunity to earn interest income constitutes an incentive to save, and the requirement to pay interest constitutes a disincentive to borrow.

How does humanity ensure that intended surpluses match intended deficits? If the intentions do not match, we find ourselves in a state of financial *disequilibrium*, or imbalance. When there is not an equilibrium, then some parties find themselves having unintended surpluses or deficits, and an adjustment process takes place as parties try to avoid such unintended outcomes in the future. (Again, by definition, actual surpluses must equal actual deficits.)

The first adjustment mechanism is a 'quantity' mechanism; it means that people simply adjust their future intentions in light of present outcomes.

The second adjustment mechanism is a 'price' mechanism. It is the rate of interest. It works – or at least should work – like this. If intended surpluses exceed intended deficits, the the interest rate should fall. A fall in interest rates reduces the reward for a surplus, and reduces the cost of a deficit. As the critical price that facilitates the negotiation process – the negotiation from incomes to spending (Pie 2 to Pie 3) – there is no reason whatsoever why the 'risk free' rate of interest should be positive. If, when interest rates are zero, intended surpluses exceed intended deficits, then the relevant market price needs to fall; in this case interest rates need to fall below zero, disincentivising surpluses and incentivising deficits.

The 'liberal' view of money and financial markets – as well as the mercantilist view – that makes this price adjustment very difficult.

In the mercantilist view – or at least the Protestant and Jewish views – interest payments have become an entitlement. (Contrast Muslim finance, which regards interest payments as usuary, and Catholic views which were very similar to Muslim views until the sixteenth century; these views however did not consider interest as a market price that could be negative, rather usury was seen as tantamount to extortion.)

In the liberal view, interest is either a variant on 'profit', or is a tool that is used to engineer the price of commodity money. Liberals are very uncomfortable with the idea that interest rates could be negative; uncomfortable to the extent of departing from cherished principles around the workings of markets. Yet ostensibly liberal regimes in Scandinavia and Switzerland have adopted negative interest rates as means to lower the prices of their countries' currencies (Krona and Franc).

For liberals, the interest rate is a manipulable price that is used to ensure that the price (ie exchange rate) of national (commodity) monies are set where their governments (and associated elites) want those prices to be; generally to give a 'competitive advantage' or at least to avoid a 'competitive disadvantage'. Competitive advantage is a mercantilist term, that represents a setting that facilitates a nation achieving a financial surplus with respect to other nations (equivalent to the balance of trade surpluses sought in the mercantilist era); or at least represents the determination – through non-market means – of an exchange rate that will avert a 'current account deficit'.

Interest

So, in the capitalist market economy, the interest rate is a market set price – like any other equilibrating price – that 'negotiates' a balance between decisions by parties to run surpluses and decisions to run deficits.

A capitalist economy with too many intended surpluses and too few intended deficits is an economy that 'overproduces' or 'underconsumes'. Planned lending exceeds planned borrowing. The market remedy is a fall in interest rates.

A capitalist economy with too few intended surpluses and too many intended deficits is an economy that 'underproduces', and some parties find their spending intentions are not able to be fulfilled. Planned borrowing exceeds planned lending. The market remedy is a rise in interest rates.

However, in liberal mercantilist economies, this price mechanism is disabled. So financial balance has to be moderated through quantity mechanisms. Examples of these exist in the labour market, and include the unemployment of commodity – essentially 'unskilled' – labour, and a lack of investment in skilled labour.

(The 'machinery' component of the GDP pie includes vocational education/training as well as construction and power machinery.)

(We may also note that economic growth is a liberal mercantilist objective, and that liberal mercantilists believe that parties wishing to buy machinery are routinely crowded out of the market, as a form of market failure. In one variant of this view, higher interest rates generate household surpluses, allowing firms to run deficits, and raising the ratio of machinery to enjoyments in the GDP pie; essentially in this view firms have a near infinite willingness to run deficits. A variation of this idea is that business borrowing is sensitive to interest rates, and that it is the role of public finance to ensure that interest rates are low enough for these firms, but high enough to ensure that households run surpluses.)

When interest rates are 'inelastic', they have to fall further to generate the equilibrium that achieves financial balance – ie that achieves intended surpluses summing to zero, given that deficits are negative surpluses.

On the whole, it appears to be governments, as economic parties, for whom interest rates are particularly inelastic. Yet governments are uniquely placed to resolve financial imbalances.

Governments as Borrowers and Spenders (and Insurers) of Last Resort

Governments are generally favoured debtors, because they (and only they) have the legal right to levy taxes. Governments are thus uniquely creditworthy, and are therefore the obvious candidate to run deficits at times when too few parties are planning to – or being allowed to – run deficits. Some governments are less favoured than others – they have less capacity in practice to service debts. And governments at the sub-national level are subject to significant constraints in their abilities to raise income to service debts.

Nevertheless – and from a global perspective – governments (especially governments of large countries) are uniquely placed to ensure that sufficient deficits happen. They may respond both to price and to quantity signals, and their actions as borrowers of last resort can serve to prevent interest rates from becoming negative (or highly negative).

There is no limit to the extent that such governments can run deficits, as we remind ourselves that the only circumstances in which 'repayment' – as opposed to interest servicing – is required are when private parties are wanting to run prolonged deficits on a substantial scale. Historically, this would constitute highly unusual behaviour from the collective private sector. Further, the spending that results from private deficits leads to substantial tax revenues (and royalty revenues once democratic capitalism is adopted), making it relatively easy for governments to run surpluses.

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maybe use word 'party' instead of 'person' or 'agent'