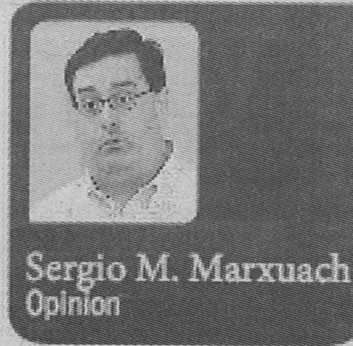
Doing away with another barbarous relic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Opinion

In 1923 John Maynard Keynes published his Tract on Monetary Reform, which was his first attempt to analyze the monetary instability that plagued the post-World War I world. In classic contrarian fashion, one of Keynes' conclusions was that central bankers — by shackling themselves to the "barbarous relic" of the gold standard — were actually exacerbating monetary problems. Liaquat Ahamed tells us in Lords of Finance, his fascinating history of that era, that Keynes was roundly criticized by other economists of the time while some central bankers considered his ideas "as being the product of a vivid imagination without very much practical experience." History, however, was kinder to Keynes, and most economic historians today consider that blind adherence to the gold standard only served to intensify the multiple economic crises that led to the Great Depression.

An important lesson from this episode is that economic policymakers should not take actions that may worsen a crisis only for the sake of preserving theoretical purity. Yet, governors in most states in the U.S. and in Puerto Rico are forced to do precisely that in order to satisfy the legal requirement of balancing their budgets no matter what happens to the real economy, even in times of recession. During the recent economic crisis governors across the nation have been forced to increase taxes, cut back expenditures, or implement a mix of both in order to balance their budgets. The problem is that those actions are extremely procyclical when undertaken in a recessionary environment. In plain English, increasing state taxes or reducing state government spending may actually deepen the ongoing recession. Furthermore, states are cutting back services precisely at a time when demand for them is at a high point, putting further stress on America's most vulnerable families.

Balanced budget requirements were initially legislated to protect bondholders that lent money to state governments. The rationale was that a government's ability to pay its obligations, which depends primarily on the state's tax revenues, would be enhanced if states were not allowed to spend in excess of those revenues in any given year. And this protection certainly works when the economy is growing and tax revenues are rising. However, when the economy is in a recession and tax revenues are, therefore, decreasing, balancing the state budget may worsen the recession and produce an even greater decline in tax revenues. Thus, payment to the bondholders, far from being secured, is actually put in greater peril by the balanced budget requirement.

These legal requirements are pernicious in another way. By forcing state governments to balance their budget every year, this legal requirement may actually give an incentive to state legislatures to engage in harmful fiscal practices to sweep deficits under the rug. During normal (non-recessionary) economic times the balanced budget requirement becomes little more than a legal fiction, as state legislatures use all sorts of non-recurring revenues and other accounting gimmicks to "balance" the budget. The result of engaging in these practices is to present a false picture of fiscal health, by covering the real fiscal problems of the state with all sorts of financial cosmetic measures. Inevitably, when a recession finally comes, the state's finances are much weaker than previously thought, forcing an even greater restructuring at the worst possible time.

That is certainly the case we are currently witnessing in Puerto Rico where during the past twenty-odd years policymakers have displayed an amazing talent for devising ways — such as using one-time revenues and borrowings to cover recurring expenses, postponing mandatory expenses or transferring them to off-balance sheet funds, and dipping into reserve accounts, among other assorted fiscal shenanigans — to dress up the financial books. The current administration claims that Puerto Rico's budget deficit amounts to $3.2 billion, or approximately 33 percent of its general fund expenditures, including $1.3 billion in mandatory or otherwise recurring expenditures that were not budgeted for the current fiscal year. While the political opposition and other private sector groups have questioned the administration's figures, the underlying reality is that the island's public finances are far weaker than expected. The administration has responded by implementing a $3 billion package of enhanced enforcement measures, increased taxes, and expenditure cuts that will almost certainly worsen the recession in Puerto Rico, which is currently in its third year.

It would be more efficient to eliminate the legal balanced-budget requirement and replace it with stricter uniform financial disclosure requirements for state governments, perhaps on a quarterly basis. That way, bondholders would have a more reliable and up-to-date financial information to guide their decisions. The bond market would keep states in line during the good times, punishing those that are not sufficiently thrifty. During recessions, however, state governments would not be forced to implement counterproductive measures that carry with them significant social costs.

In sum, during recessions state balanced-budget requirements put additional downward pressure on the economy; force states to cut back services to low-income families when those services are needed the most; and do not work to protect the interests of bondholders. Perhaps it is high time to do away with another barbarous relic.

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