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A Post Keynesian Perspective**

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Fiscal Policy and the Washington Consensus: A Post Keynesian Perspective

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Abstract

The debt crisis of the early 1980s prompted several analyses that emphasized the negative role of fiscal deficits on economic development. This negative view of fiscal deficits was consolidated in the so-called Washington Consensus agenda. International financial crises – recurrent in a world of true uncertainty with unregulated capital flows, and flexible exchange rates – have led to perennial fiscal adjustment. Alternatives to the permanent fiscal adjustment, the main legacy of the Washington Consensus, from a Post Keynesian perspective, are presented. It is emphasized that the notion of the euthanasia of the rentier is a necessary complement to the socialization of investment.

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Crises are usually catalysts for change, and debt crises are no different. The wide spread debt crisis in what used to be called the Third World – in particular in Latin America – in the 1980s corresponds to a period of transition in the cycles of State intervention. In Latin America the reinvigorated role of the State after the depression of the 1930s took the form of an Import Substitution development strategy. The Latin American debt crisis is the landmark that divides the Import Substitution Industrialization (ISI) strategy, devised under the intellectual guidance of the Economic Commission for Latin America and the Caribbean (ECLAC), and the market friendly approach, institutionalized by the International Monetary Fund (IMF) and the World Bank.

There is a fundamental difference between crises where a country's underlying debt position is sustainable over the long run and those where debt restructuring is unavoidable. Many thought that the crisis unleashed by the Mexican default of August 1982 was of the former type. The crisis, however, was more lasting and acute than expected, and, in fact, the 1980s became known in Latin America as the lost decade. By the mid-1980s most analysts were certain that the crisis was going to be long lived and some argued that a radical change in the development strategy was necessary. The policies that were suggested – and then imposed in the context of international agreements – and that eventually became known as the Washington Consensus (Williamson, 1990), are, therefore, the result of need for a new development strategy.

In many respects, the crisis of the developmental State, and the Debt Crisis represent for Latin America what the so-called fiscal crisis of the State does for the developed world. In that respect, the market friendly approach to development is the other face of the conservative revolution of Reagan and Thatcher in the developed world.

Fiscal discipline was the first item in Williamson's decalogue, the others basically argued for deregulation, liberalization, and privatization, and as noted by Davidson (2003, p.3) "all ten reforms of the Washington Consensus [were] founded on classical economic theory that supports the *laissez-faire* doctrine as necessary to solve all our economic problems." The emphasis on fiscal discipline was associated to the concern that high fiscal deficits were behind macroeconomic instability, on the one hand generating inflation, and on the other, by generating fears of default leading to balance of payments problems. Populist macroeconomic policies, meaning lax fiscal policy, were in the consensus view the cause of the lost decade (Bresser Pereira and Dall'Acqua, (1991).

The result of the implementation of the Washington Consensus policies in Latin America has been a commitment to maintaining primary surpluses (excluding interest payments) even in periods of recession. This is a significant change with respect to the Keynesian views that dominated before, one that is more extreme than the anti-Keynesian bias in the developed world. In particular, primary fiscal

surpluses and open capital accounts have generated an environment that has curtailed public investment. This paper discusses these developments in light of Keynes' own views on fiscal policy. It is emphasized that the notion of the euthanasia of the rentier is a necessary complement to the socialization of investment. The following section will discuss what Keynes really said about fiscal policy. We contrast Keynes' view with the Washington Consensus view, and we offer an alternative based on Keynes' ideas and post-Keynesian critiques of the consensus (Davidson, 2003).

Keynes on Fiscal Policy

In popular textbook presentations Keynesianism is represented by deficit spending. Keynes himself defended public works and deficit spending since the late 1920s, and particularly during the long debates of the Macmillan Committee (Clarke, 1988).¹ In particular, he did not believe that such spending would crowd out private spending as argued by Treasury officials. Public spending did not use in Keynes' view a given pool of savings – which would reduce the loanable funds to private agents – but, on the contrary, by increasing the level of activity, it led to higher aggregate savings.²

However, Keynes emphasized the importance of balanced budgets in the long term (Carvalho, 1992; Brown-Collier and Collier, 1995). Keynes was keenly aware of the limitations of fiscal policy in times of recession. He noted that time

lags would make fiscal policy a second best solution for a recession (1980b, p. 22 and 1973, p 49). More importantly, Keynes noted that budget deficits have a cyclical component, and that deficits were just a symptom of insufficient spending, investment above all. In other words, in a recession tax revenues decrease, spending programs (e.g. unemployment insurance) imply higher government expenditures, and a deficit results. Deficits are an effect of a recession, and do not represent a reliable solution.

If deficits were the result of a recession, the best way to avoid them was to stabilize the cycle by stabilizing investment, and the best instrument at hand was public investment. In the *General Theory* itself Keynes (1936, p. 378) argues, in one of his most controversial propositions, for “a somewhat comprehensive socialization of investment.” Keynes (1936, p. 378) also warned that the socialization of investment did not preclude “all manner of compromises and devices by which public authority [would] cooperate with private initiative.” Socialization of investment was not devised as “a terrific encroachment on individualism, [but], on the contrary ... as the only practicable means of avoiding the destruction of existing economic forms [that is, capitalism] in their entirety and as a condition of successful functioning of individual initiative,” (Keynes, 1936, p. 380).

Consistent with his emphasis on counter cyclical public investment Keynes argued for a separation of the current or ordinary budget and the capital budget.

The first was related to government consumption and should be balanced on average or even in surplus to finance the capital one. The latter was related to public investment and should be used for counter cyclical purposes. The main difference between the two types of expenditure is that whereas consumption implies immediate fruition, capital expenditures provide a real return over time. Further, by creating a favorable expectational environment for private investment, capital expenditures would help stabilize the level of output. In that respect, tax policies and public works which involved deficit budgeting should be relegated to secondary plane and capital budgeting should be the central instrument of fiscal policy.

It is clear that as much as deficit budgeting, capital budgeting may lead to the accumulation of public debt. Keynes (1980b, p. 366) notes, however, that government debt is of no concern provided it does not get “out of proportion to the growth of the national income.” His ideas on debt sustainability are in line with the notion of functional finance as developed by Lerner (1943), and with the debt sustainability theorems developed in line with Domar (1944). However, Keynes’ never became a Lernerian, in the sense of being in favor of deficit spending as a solution for unemployment.³

Hence, Keynes favored public investment financed by public borrowing, and taxes should be budgeted with a view of making debt servicing payments over the life of the investment project. However, it would be incorrect to presume that

Keynes views on fiscal policy stop at this stage.⁴ The euthanasia of the rentier was an integral part of the analytical framework of the *General Theory*. The euthanasia of the rentier would imply low rates of interest, which not only would provide a better environment for private investment and full employment, but also it would make debt servicing, and, hence, public investment economical.

Keynes (1936, p. 335) noted that "in a society where there is no question of direct investment under the aegis of public authority, the economic objects, with which it is reasonable for the government to be preoccupied, are the domestic interest rate and the balance of foreign trade." That is why to guarantee the euthanasia of the rentier, Keynes pointed out that the central bank should be able to set the rate of interest independently from any international pressures. Keynes especially insisted upon the idea that movements of capital could not be left unrestricted, during the long preparatory works and the negotiations for the Bretton Woods conference. Keynes argued "we cannot hope to control rates of interest at home if movements of capital moneys out of the country are unrestricted" (1980a, p. 276). If, however, the government permits capital funds to freely move across national boundaries, then according to him (1936, p. 336) "the authorities had no direct control over the domestic rate of interest or the other inducements to home investment." Hence, capital controls are the necessary complement to Keynes' fiscal policy proposals for current and capital budgeting and the socialization of investment.⁵

The Consensus and Fiscal Policy in the Periphery

To understand the Washington Consensus views on fiscal policy we must introduce one more distinction, beyond the current and capital budgeting one introduced by Keynes. Fiscal discipline in general is associated with nominal fiscal results. In other words, discipline hinges on whether the government (in all its levels) has a surplus (or not) over its expenses. Yet, the fiscal deficit can be subdivided into its financial and non-financial components. The primary fiscal balance excludes the interest payments incurred by the servicing of the outstanding debt, and hence portray the non-financial part of the fiscal accounts.

According to Williamson (1990) one of the main Latin American problems was the widespread use of fiscal deficits as a macroeconomic policy tool.⁶ That is why fiscal discipline was the number one item in his list of policy recommendations. If one looks at nominal fiscal balances, one must agree with Williamson. However, if we look at the primary figures the picture of fiscal performance for Latin America is not inconsistent with the consensus.

If we take the three biggest Latin American countries – Argentina, Brazil and Mexico – it is clear that since the debt crisis of 1982 there has been a resolute fiscal effort. Mexico has had primary surpluses since 1983. Argentina and Brazil had maintained on average primary surpluses in the 1980s and 1990s even though in some years there were primary deficits. In all three countries the

nominal deficits have been relatively large.⁷ The difference between the primary surpluses and the nominal deficits is made of interest payments. One may ask then, what is the effect of the fiscal policy mix (primary surplus and nominal deficit) that the main Latin American countries maintained since the debt crisis and continue to pursue, in part as a result of negotiations with the IMF.

The conventional view of fiscal deficits is that in the short run they stimulate the economy, but in the long term, given that national savings equal domestic investment and net foreign investment, then a fall in national savings (public deficits) must lead to a fall in capital formation or net foreign investment. In both cases the level of growth must fall. Put simply, deficits are good in the short run, but not in the long run. Sometimes the negative long-term effect on growth is presented as the result of rising interest rates leading to lower capital accumulation.⁸ The higher rates of interest result from the decrease in national savings. In other words, public spending crowds out private spending. Leaving aside the logical problems with the crowding out argument – tackled long ago when Keynes debated the so-called Treasury view – there is very little evidence that deficits affect the rate of interest (Gale and Orszag, 2003, p. 475).⁹ Further, the Latin American experience suggests that the causality between interest rate and fiscal deficit is reversed. That is, a higher interest rate will lead to higher interest payments on debt, and higher nominal deficits. The reasons for that are twofold. First, central banks in the region tend to maintain high interest rates (short term interest) to avoid capital flight. Second, part of the public debt is

indexed to the short term interest rate. As a result, monetary policy translates into high debt servicing.

Whatever the effects of public deficits on growth, then, those results cannot be brought about by higher rates of interest, in the Latin American context, since deficits have limited impact on rates of interest. Income distribution is, however, affected by this fiscal policy mix. A primary surplus together with a nominal deficit implies that the government is paying the difference to debt holders. Usually debt holders are wealthy individuals, corporations, and banks. In other words, the combination of primary surplus cum nominal deficit represents a transfer of resources from society as a whole to wealthy debt holders. The redistributive process has strong social consequences since in most cases primary surpluses imply that social spending has to be squeezed (Grunberg, 1998).¹⁰

Therefore, the effects of fiscal deficits on the level of activity are mediated by income distribution rather than the rate of interest. In wage-led economies redistribution towards debt holders, with lower propensities to consume, should lead to output stagnation. In other words, in wage-led economies, financial liberalization that promotes integration to international financial markets, coped with large primary fiscal surpluses, promotes stagnating rates of output growth. The stagnationist scenario would be reversed in a profit-led economy. However, anecdotal evidence suggests that Latin American countries tend to be wage-led,

resulting in a more likely stagnationist scenario.¹¹ In that sense, the long run effects of the fiscal deficits are negative, but the reasons have nothing to do with public spending crowding out private spending.

The question to be asked then is why a country would promote a severe fiscal adjustment, in terms of the primary target, if the final effects turn out to be low levels of output growth and worsening income distribution. The primary deficit is a very narrow concept, and it was well known since the times of Keynes that deficits are not good measures of the fiscal stance. In other words, primary targets do not allow controlling aggregate demand. The reason for using the primary deficit as target for policy, with the implicit objective of maintaining a stable debt to GDP ratio, is related to the effects of globalization. In an open economy the rate of interest is set to keep the foreign exchange under control, and to avoid capital flight, as Keynes warned in the Bretton Woods discussions. As a result, the interest payments on debt cannot be controlled, in particular, because the debt is indexed to the base rate of interest determined by the monetary authority. Accordingly, the only variable left for the government to try to control the debt to GDP ratio is the primary surplus, and that is why the IMF imposes primary surpluses on developing countries.

In this respect, one should note that primary surpluses have little, if anything, to do with generating credibility. Foreign investors, concerned with foreign debt, should look at the export performance of the country, the only secure source of

foreign reserves, rather than primary fiscal balances. Unless one assumes that foreign investors are irrational, the credibility argument seems of limited relevance.

The practical effect, then, of the Washington Consensus policies in Latin America is to promote a permanent primary surplus. Beyond the income distribution implications spelled out above, the second and crucial effect from a post-Keynesian perspective, is the effect of primary surpluses on public investment. Public investment, as we saw, was the main instrument of fiscal intervention devised by Keynes in his *General Theory*. Primary surpluses in the context of an open capital account imply that the biggest part of the government goes to interest payments. The practical effect is that public investment is squeezed by debt servicing spending, and the revenge of the rentier, in Pasinetti's (1997) apt expression, instead of its euthanasia, takes place. In sum, the Washington Consensus renders Keynes' socialization of investment impossible in the periphery.

A Post-Keynesian Alternative

The IMF has been for all practical purposes the enforcer of the Washington Consensus in Latin America, and elsewhere in the developing world. Critics correctly characterize the IMF's fiscal policy advice as "one-size-fits-all," that is, is not tailored to the specific circumstances of the country, which in fiscal matters

translates into reducing fiscal deficits. The IMF's prescription of fiscal austerity restricts economic growth and social expenditures, thus harming the poor in particular. In addition, we argue that the IMF's emphasis on primary surpluses and open capital accounts has led to a squeeze of public investment, and the ability of Latin American countries to pursue counter cyclical fiscal policies along Keynesian lines.

The share of public investment in GDP, and especially the share of infrastructure investment, has declined during the last three decades in a number of countries, particularly in Latin America. Since the private sector has not increased infrastructure investment as Washington Consensus authors have hoped for, significant infrastructure gaps have emerged in Latin America. These gaps adversely affect the growth potential of those countries and limit social development. Not only are the governments of these countries now seeking to reverse the declining trend of public investment, partly through increased resort to private-public partnerships (PPPs), but also multilateral development banks have signaled that they are prepared to redirect some of their lending to infrastructure projects, in order to close infrastructure gaps.

Against this background, questions have been raised about the widely used approach to fiscal analysis and policy, which focuses on the primary fiscal balance even within the IMF (e.g. IMF, 2004). A major concern, according to the IMF, is that this approach may unduly constrain the ability of countries to take

advantage of increased opportunities to finance infrastructure projects. In this context, some have advocated shifting to the current fiscal balance (which excludes public investment) as the fiscal policy target of choice. This change would correspond to Keynes' own views on fiscal policy.

More importantly, in Latin American countries the operations of public enterprises are included in the fiscal indicators and targets imposed by the IMF and as a result they improperly restrict public investment. The IMF (2004) admits that, indeed, the coverage of fiscal indicators and targets varies significantly across countries, with coverage being in general broader in Latin America than elsewhere, and that this is reflected in IMF-supported programs. Post-Keynesian theory, based on Keynes' views on fiscal policy, suggests that the exclusion of the operations of public enterprises from fiscal indicators in countries where currently the entire public sector is covered is an essential step towards sound fiscal policy. This would allow public firms to carry part of the burden of public investment. One should add that investments in infrastructure usually have a crowding-in effect, leading to higher levels of private investment.

However, even if the IMF has started to discuss the problem of public investment, it has been more moderate with respect to the effects of capital account liberalization, and its effects on interest rates and public finances.¹² Developing from Keynes' *General Theory* and Bretton Woods' writings post-Keynesian analysis (e.g., Davidson, 2003) demonstrates that what most orthodox

economists mean by a policy of fiscal discipline will not produce a fully employed economic system.¹³ This point is corroborated here, since primary surpluses cum high interest rates – the former imposed by the IMF and the latter resulting from an open and deregulated capital account – will continue to constrain the ability of the government to pursue counter cyclical fiscal policies.

Post-Keynesians have long emphasized the need for greater regulation of global capital markets, and some propose new international institutions such as a World Financial Authority (Eatwell and Taylor), an International Monetary Clearing Union (Davidson) or a publicly controlled international transaction system (D'Arista).¹⁴ A more comprehensive reform of the international financial system, along Keynes' proposals at Bretton Woods, as advocated by post-Keynesians, however, is necessary not just to stabilize financial markets and reduce balance of payments crises. A more closed capital account would allow lower rates of interest, lower debt servicing spending, and more space for public investment. International financial reform is the necessary complement for sound fiscal policy in the periphery.

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NOTES

¹ Pérez Caldentey (2003) suggests that Keynes' recanted from his early support of public works, and used the framework developed in the *General Theory*, which put emphasis on stabilizing investment, as the main tool of counter cyclical fiscal policy. The argument is further developed below.

² In fact, as Keynes (1936, p. 64) notes "savings is a mere residual [and] the decisions to consume and the decisions to invest between them determine incomes."

³ For a discussion of functional finance see Forstater (1999). For a discussion of Keynes' views on Lerner's functional finance see Colander (1984). Colander (1984, p. 1574) suggests that the main reason for Keynes' objections towards functional finance were related to the political implications of such policies. However, the distinction between ordinary and capital budgets hints that sustainability implications of consumption versus investment spending might have had a role too.

⁴ Note that Brown-Collier and Collier's (1995) well written and otherwise detailed analysis of Keynes' fiscal policies views omits discussion of interest rates and the euthanasia of the rentier.

⁵ It is important to mention that during the Bretton Woods capital controls were widespread, but Keynesian policies regarding current and capital budgeting were not. On the second point see Brown-Collier and Collier (1995).

⁶ Williamson (2003) has recanted some of his original views, but not the main thrust of his initial proposal.

⁷ For the Argentinean fiscal efforts see Damill *et alli* (2003), and for the Brazilian fiscal experience see Câmara and Vernengo (2002). In both cases the idea that fiscal crisis were behind the balance of payments problems is refuted.

⁸ As we saw in the previous section, Keynes rejected the crowding out argument.

⁹ Gale and Orszag (2003) argue that the evidence is mixed at best, but that most macroeconomic models in the US imply a small but significant positive correlation between interest rates and public deficits. Causality is never questioned though.

¹⁰ The paper will emphasize the liberalization of the capital account rather than the trade account of the balance of payments. Trade liberalization impacts the fiscal accounts by reducing tax revenues, a pressing problem for the poorest developing countries (Grunberg, 1998; Toye, 2000). Capital account liberalization affects interest rates and, therefore, the financial component of government spending, which seems to be more relevant for middle income countries.

¹¹ For structuralist models with wage and profit-led regimes, and discussion of its applications to developed and underdeveloped economies see Taylor (2004).

¹² The IMF has recently admitted that the evidence on the effects of capital account liberalization has been, on the whole, negative. See Prasad et al. (2003).

¹³ One should note that Davidson (2003) also points out correctly that the orthodox view of fiscal discipline will not guarantee the absence of balance of payments crises.

¹⁴ Others have also proposed alternatives to the current system, e.g. Soros' proposal of a new allocation of special drawing rights (SDRs).