POLICY BRIEF
2024-10-044, OCTOBER 2024
ISSN # 2094-3342

De La Salle University
AKI
Angelo King Institute
for Economic and Business Studies

Filipino capitalists, UNITE!

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By Jesus Felipe and Beatrice Elaine Banzon

NOTHING is more untrue than the claim of key economic departments that reductions in the budget deficit and the national debt are good for the economy. The Senate and Congress argue the same way, as well as the rating agencies and multilateral institutions. These claims reveal bad economics. Those who espouse such seemingly correct objectives do not appear to understand the operational reality of government finances, especially that running a fiscal deficit is not a sin, and the role of national debt for monetary policy. Our managers treat the economy like accountants in a firm or a family, where recurring expenditures above revenues is indeed a problem.

Unfortunately, the private sector has come to support such views because its members believe that lowering the fiscal deficit and national debt will benefit them. The reality is that both benefit the private sector.

This incorrect way of thinking derives from a series of fallacies that we address below. What follows is factual:

Fact 1: The government cannot run out of its own money because its finances are not like those of a family or a firm.

There is a generalized perception that a fiscal deficit is bad because of the negative connotation of the terms "deficit" and "debt," together with the belief that the government's finances are like those of a family or a firm. This is incorrect. While a family and a firm do have a budget constraint such that they cannot consume or spend forever beyond their income, sovereign governments can run deficits in their own currency because it is fiat money. This is government-issued currency that is not backed by a commodity.

This does not mean that governments should spend as if there is no tomorrow. It simply means that they are not bound by the family budget constraint. No country can run out of its own money to make payments. The government's banker is the Central Bank, which creates money, the Peso in our case, *ex nihilo*. The fact is also that governments make payments by crediting bank accounts through electronic transfers. Governments can make as many such electronic transfers as they want to.

Wake up: governments do not spend with your taxes. Do you believe that developed countries build and pay for their vast highway systems, public schools, or hospitals with taxes? Although governments may have passed laws that impose accounting constraints about when and how to make payments, this does not change the fact that they use fiat money to make payments through electronic transfers, with or without taxes. Therefore, the statement "the government does not have money" is fallacious.

Fact 2: The government's fiscal deficit creates a private sector surplus, peso for peso.

Government payments are recorded as a series of debits and credits in the accounts of the government itself, central bank, commercial banks, and households. A government payment ultimately shows up as a credit in someone's account. Why would the private sector complain when the government transfers more to it (let's say P100) than it pays to the government in taxes (let's say P50)? Does anybody prefer the reverse situation? Taxes lower private sector income and thus, "your" consumption.

Fact 3: The term "national debt" is misleading because it only reflects one side of the double-entry accounting.

While Treasury Notes are debt from the government's point of view, they represent wealth from the private sector's point of view because its members own them. The Philippine sovereign government will never have problems servicing debt in its own currency. Treasury Notes are investments offered to the Filipino private sector in exchange for its liquid funds. The Notes offer interest and carry zero-default risk. Why complain about it? From the private sector's side, it is manna from heaven. If national debt above a certain imaginary level (the famous 60%) was a real problem, some advanced economies would have already disappeared from the map.

From the Central Bank's point of view, issuing debt is an interest management operation. A fiscal deficit (the difference of P50 in the above example) materializes as excess liquidity in the banking system: credits to the private sector (expenditure) are larger than debits (taxes). This pushes interest rates down. To maintain its target policy rate, the central bank will need to coordinate with the Treasury to mop up that excess liquidity by issuing debt. Some Treasury and Central Bank officials do not seem to realize that this is what they do.

Fact 4: Budget deficits do not crowd out private investment.

Often, the argument is made that government spending and private investment compete for a finite pool of savings, and this competition must be resolved with higher interest rates that damage private investment. Hence, fiscal deficits crowd out private investment. The crowding out argument is, however, without substance. First, it relies on the wrong claim that savings are finite, and borrowers like firms and the government have to compete with each other to gain access to that finite pool. Second, as pointed out above, fiscal deficits put downward, not upward, pressure on interest rates.

Fact 5: A fiscal deficit is part of the private sector's aggregate profits, as reflected in the national accounts.

It is not difficult to show that Aggregate Corporate Profits = Entrepreneurs' Consumption + Entrepreneurs' Investment – Workers' Savings + Trade Balance + Fiscal Balance. Workers' savings are minimal in the Philippines. The last two terms, the trade balance and the fiscal balance, are positive with a surplus and a deficit, respectively. While this equation is true by definition, it is totally missed by the government and the private sector.

The equation indicates that total profits that owners of capital collectively receive are equal to the right-hand side of the equation. The relationship highlights the importance of the trade surplus and the government deficit: either of this (if positive) enables capitalists to earn profits in excess of their own expenditures and private investment.

In the case of a trade surplus, extra profits come from the excess of national income over domestic expenditure due to a surplus of export earnings over import spending. This implies that there is a rational basis for countries' efforts to achieve and maintain trade surpluses as these tend to boost the profits of domestic firms (holding other factors constant).

A fiscal deficit is expansionary because it is equivalent to a private sector surplus with the government. Therefore, deficits provide an increased capacity for entrepreneurs to realize their production plans and sell output as they expand the total aggregate demand in the economy.

A fiscal surplus, on the other hand, leads to reduced profits. With a fiscal surplus, aggregate spending falls, which reduces the revenue that firms receive. Moreover, if the surplus is achieved with increased business tax rates, then the firms have lower after-tax profits. In most circumstances, a fiscal

surplus is deflationary. While it may be appropriate in some circumstances to reduce a fiscal deficit, and even run a surplus, this would pose a problem for the Philippine private sector unless we simultaneously managed to run a current account surplus. It is also incorrect to think, as a general rule, that a country that runs a fiscal surplus is better managed than a country that runs a fiscal deficit.

The arguments above have important implications for development. We do not claim that the government should spend as if there's no tomorrow. Rather, our claim is that it should use the power it has to issue and spend its own currency, in order to pursue public purpose and well-being. Such a government should spend whatever is necessary to bring the economy as close as possible to full employment, to provide all basic needs including high-quality education and health, to construct infrastructure, and to guide the economy toward sectors that require workers with high skills and pay high wages — this is good economics and development. Government spending is a tool to attain these objectives, not a capital sin.

When the economy expands, to a significant extent thanks to government spending, the deficit and national debt will represent a smaller share of the GDP. The limit to government spending is inflation, resulting from the fact that the economy is operating at full employment. Constraining spending beforehand is a serious policy mistake.

Plea to the government and the Central Bank: unless we become an exporting nation and run a current account surplus, you will have to run a fiscal deficit if you want to pursue the nation's well-being. It will be your best ally to manage the economy. Do not force a reduction in the deficit, much less a surplus. Issuing Treasury Notes is a must as it helps ensure that the Central Bank hits its target interest rate.

Plea to the Filipino capitalists: the next time you hear the government bragging about the reduction in the fiscal deficit and the national debt, do not be fooled: the government is ripping you off of your profits. Embrace Karl Marx, unite and strike.