

In defense of the Holy Fiscal Deficit: Accounting and economics

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Part I: The dislike for fiscal deficits and the reality of their role in the economy

THERE APPEARS to be a broad consensus across the different sectors of our society that fiscal deficits are to be avoided. The rationale is that a government cannot spend more than it collects in taxes, certainly not routinely. With some nuances, the business community, government officials, academics, bankers, journalists, and the average person on the street, are aligned in thinking that a fiscal deficit damages the economy. We need to be fiscally responsible, like a good family. Fiscal deficits bring back memories of the 1980s, today even more so in the face of the corruption scandal. On top of this, we have been influenced by the IMF and the World Bank's policies and way of thinking.

In this three-part series, we will argue that this widespread understanding of fiscal deficits is incorrect. Underlying it are three fundamental errors — deeply entrenched beliefs. One is that the finances of the nation are like those of a family or a firm. Second, that the money that the government uses to make payments is taxes. Indeed, society at large believes that taxes finance spending, in the sense that the government needs to collect taxes prior to spending, and that taxes are used by the central government to spend. And third, that pesos are a resource, something scarce like oil.

All three are incorrect, and do not correspond to the reality of government spending and taxation in a modern economy.

In what follows, we elaborate upon a series of arguments, based on facts, that explain what a fiscal deficit is and its role in the economy, and argue that apprehensions about it are, in most cases, groundless. We hope the article contributes to dispelling this widespread belief.

Before we proceed, we stress that it is obvious that government spending has to be judicious and that corruption has to be eradicated. But it is important to understand that running a fiscal deficit is not tantamount to being corrupt or inefficient. Our government might be criticized but not because it runs a deficit.

Let us start with the simple fact, missed by most people, that a government (fiscal) deficit means that the government spent more on services for all of us than it collected in taxes from us. If the government runs a deficit, the private sector must run, on aggregate, a surplus. Naturally, it matters what the government spent on but that is a different issue, however important. This point is crucial so let us stress it: a fiscal (government) deficit occurs when the difference between what the government collects in taxes and what it spends as summarized in the national budget (roads, bridges, schools, hospitals, etc.), is negative. To make this crystal clear, it means that the private sector receives more from the government in terms of infrastructure payments (a company that was awarded a contract to build a road or a school; civil servant salaries) than it pays in taxes. A fiscal deficit increases the net worth, that is, saving, of the private sector. Complain about this? Want to reverse it? It is ironic that the business community does not seem to grasp what a fiscal surplus would do to the private sector, namely, we would pay more in taxes than the government would spend on services. Is this what they advocate?

Looking at the government's fiscal position in isolation is bad economics. The reason is that there is a crucial connection between the fiscal position (Taxes minus Government Spending, let's call this difference A) and the other two key sectoral balances of the economy: that of the domestic private sector (Private Saving minus Investment, let's call this difference B,) and the current account (the foreign sector, essentially exports minus imports, let's call it C). The three sectoral balances add up to zero by construction as follows: $A + B - C = 0$ (with these signs). It is the result of how the national accounts are built. This is the same in every country and it has to be so for good economic reasons. Not understanding the economics that underlies the link among the sectoral balances leads to erroneous statements.

As noted above, the three sectoral balances, government, domestic private sector, and foreign sector, add up to zero by construction. This means that if the government runs a deficit of, for example, 5% of GDP ($A = -5\%$), the private sector (jointly domestic and foreign sectors) must run a surplus of 5% of GDP ($B - C = +5\%$). Likewise, if the government runs a surplus of 5% ($A = +5\%$), you can be certain that the private sector will run a deficit of 5% of GDP ($B - C = -5\%$). This is not a theory. It is factual.

We hope the reader starts thinking about what this means and why looking at the fiscal deficit in isolation is dangerous. Let's put all this in the context of the Philippines economy. We know that in all countries, the domestic private sector prefers to run a surplus (for example, $B = +5\%$). This means that the fiscal balance and the foreign sector must run, together, a deficit of the same size ($A - C = -5\%$). Now consider the following fact. Most of the time the Philippines runs current account deficits (C is negative). The algebra of the sectoral balances tells us that for the domestic private sector to be able to run a surplus (B positive), in the face of a current account deficit, the government has to run a fiscal deficit (A must be negative). There is no other way. This is neither good nor bad but the reality. We are not an exporting nation hence the current account deficit. Moreover, we also know that domestic private sector deficits are a good predictor of crises. If we want to prevent a crisis like the one in 2008-09 in the

West (caused by large domestic private sector deficits during the years before), we need to ensure that the government provides the domestic private sector the funds to run a surplus. It is the fiscal deficit what brings macroeconomic stability to our economy.

The sectoral balances figure (shown as percent of GDP) documents these arguments. The three bars (sectoral balances) add up to zero, by construction, for each quarter. In most quarters, the Philippines runs a current account deficit (bars above zero in the graph), a fiscal deficit, and a domestic private sector surplus.

Notice the quarters in 2020: large domestic private sector surpluses that mirror large fiscal deficits (up to 10% of GDP). Government deficit hawks do not understand this. Actually, it is the economies with a private sector in deficit the ones that run into crises, as happened just prior to the 2008-09 global financial crisis, not economies with budget deficits above 3%. It was a lack of understanding of private debt that led the entire profession of neoclassical economists to famously miss the build-up of the largest household debt bubble of all time in the 2000s, while simultaneously labeling the period as “the Great Moderation.”

What is difficult to comprehend is that government officials do not seem to understand the economics of the sectoral balances either, and they aim at reducing the fiscal deficit to $A = -3\%$ of GDP by the end of the administration, as if it was a great objective and achievement. They think that this helps the economy. This is a self-imposed constraint that reduces the sustainable policy space of the nation. The reason is simple: this forces the overall private sector ($B - C$) to run a surplus of 3% of GDP. Suppose we run a current account deficit of $C = -4\%$. This implies that the domestic private sector will run a deficit of $B = -1\%$ of GDP. We insist that if with the economy that we have, including the current account deficit, the government does not run a deficit, we’d better start reciting all our prayers. The economy would enter a depression.

On the other hand, if we do not want the government to run a fiscal deficit, while maintaining the private sector surplus, we need to change the economy and be able to run a current account surplus (C positive), that is, we need to become Germany, Singapore, or Japan at some point in their history, and have their manufacturing-exporting companies. The current account surplus is the injection into the economy. They do not need another one. In fact, they need to avoid it if such a surplus is large, in which case they have to run a fiscal surplus. Changing the structure of the economy requires an industrial policy, a topic that we leave for another article.

The solution to the corruption scandal is not to kill the fiscal deficit. We would need it with and without corruption. The solution is to improve governance and punish the culprits.

Part II: The reality of how the government spends and taxes, and other misunderstandings

In **Part I of this article**, we showed that fiscal deficits generate net worth for the private sector and that, given that the Philippines runs current account deficits, the private sector can run a surplus only if the government runs a deficit.

A fundamental problem in the discussion of what the government does is the misunderstanding of how it pays for infrastructure, civil servant salaries, etc., and what happens to taxes.

When the Philippine government pays a contractor to build a road, a school, etc. it uses (every time) new money created by the central bank (Bangko Sentral ng Pilipinas or BSP). This is done "out of nothing," ex nihilo. Pesos are not scarce, and hence cannot

be treated as a resource like oil. This money is called "reserves balances" and the BSP is not financially constrained.

This is stated in RA 7653 (Central Bank Republic Act). The other way around, the taxes that we pay do not sit in a government account and wait to be sent back to us when it pays for a new project. Your bank transfers reserve balances to the Treasury's account at the BSP. Taxes disappear in the process. The system in place (the same as in any other country) treats spending as a legal instruction to the BSP, and taxes as Treasury receipts, not funding instruments. Sections 89, 110, 113, and 114 of RA 7653, imply the following: a.) All National Government receipts are credited to Treasury accounts at the BSP; b.) All Government payments are made through the BSP; c.) Every Peso of reserve used to settle government spending is created by the BSP, not collected via taxes; d.) Spending is operationally a reserve credit decision by the BSP, subject to authorization, not funding availability; and, e.) Reserve availability is a policy variable, not a Treasury constraint.

Operationally, when Congress authorizes spending, Treasury instructs the BSP to pay, the BSP credits bank reserve accounts, and banks credit private deposits. Taxes reduce bank reserves earlier (banks need reserve balances before they can settle tax payments), increase Treasury deposits, and they are accounting offsets, not payments. Summing up: spending and taxation are separate and delinked operational processes. Taxes are not parked in a special account to be used to pay for infrastructure projects. No theory. It is the law, an operational reality.

It is true that the Philippine legal framework (budget process rules like PD 1177 and the Constitution) requires that the government have appropriations and revenue sources before spending. However, the requirement to have balances prior to spending does not mean that the government is financially constrained like a household or a firm. Payments proceed as explained above. We likewise emphasize that it is a mistake to think that taxes go back into the system to finance government spending. Taxes play

several important roles in the economy (so we need to maintain them), but they do not finance spending. Taxes free up real resources in the economy (for the government) that otherwise would have been used by the private sector for private ends. They thus allow the government to spend without coming up against the inflation constraint that would be created once all resources are fully utilized.

So, what is the role of bond issuance if payments occur as explained above, and taxes do not finance spending? This brings us to the connection with the Bangko Sentral ng Pilipinas. Our central bank sets an interest rate to try to achieve its inflation target (its main goal and role), the so-called overnight reverse repurchase rate. This has been the backbone of our modern monetary policy since the early 2000s, together with the corridor system in place since 2016. What happens to this interest rate, key to managing the economy, and anchor of the interest rates in the banking system, when the government runs a fiscal deficit?

A fiscal deficit implies that there are excess reserve balances in the banking system (government pays us through the banking system and we pay taxes also through the banking system). This, invariably, puts downward pressure on interest rates, including on the central bank's policy rate (to zero), not upward pressure, as many believe. The central bank cannot allow this to happen.

The solution? The excess reserves have to be drained. How? By coordinating with the Treasury department. It issues Treasury bills and offers them to the so-called primary dealers (major financial institutions), who are very happy to buy them because T-bills offer a great alternative to keeping the funds idle. It is just a portfolio exchange.

Whoever thinks that bond issuance is an act of submission of the government with respect to the private sector should witness an auction in action. The government is clearly not borrowing from the private sector, much less in the sense that we are asked to believe, that the government is at the mercy of the private sector.

Apart from the fact that a fiscal deficit pushes interest rates downward, notice also that the initial possible inflationary impact of government spending (private spending is also inflationary) on prices is neutralized by the bond issuance, as excess liquidity (reserve balances) is mopped up. Peso depreciation as a result of using our own currency to build schools? Certainly not. But if this were the case, the groups advocating that we need a significant depreciation of the currency should jump for joy.

Primary dealers can later offer T-bills to households and firms in the secondary market. These also purchase them gladly. For us in the private sector, it is wealth. Yet, most people call this “national debt” and have a negative view of it simply because of the word, debt. In reality, it is just an accounting record of the Treasury bills in the hands of the private sector (its wealth), P17 trillion currently. Those obsessed with the national debt claim it represents over 60% of our GDP. This ratio is irrelevant. One can choose how to call it, debt or wealth, as long as what it is and who owns it is clear.

The average Filipino does not owe about P130,000. This statement is ludicrous. Yet newspapers and commentators repeat it over and over. If anything, the truth is that, on average, each Filipino owns this amount, though in reality the ownership of T-bills is highly concentrated in the financial system and households with high income.

Another important point to highlight is that T-bills are issued as an interest rate maintenance operation, not government borrowing, as is most often understood. It is intriguing to hear bankers complain about the fiscal deficit. Bond (debt) issuance brings stability to our financial system, and a large portion is in the asset side of our banks’ balance sheets.

It is important to differentiate between debt in pesos and debt in a foreign currency. The Philippine government will always pay peso-denominated debt simply because it will always have pesos to honor it. This represents about 70% of the total national debt. The other 30% is foreign-denominated. This is the potentially problematic one because

the government has to make sure it has the foreign currency to pay it. This is not a large share, and, so far, the government has been able to honor it.

There might be good reasons why the Philippine government sometimes borrows dollars, for example to purchase defense equipment. What is less clear is when the government claims that foreign borrowings are for budgetary support, if this means for items in the national budget such as education, civil servants' salaries, and the like, denominated in pesos.

For those obsessed with the debt-to-GDP ratio, they should follow just foreign-currency denominated debt. Moreover, while economists have spilled uncountable volumes of ink worrying about government debt, there is no particular "debt ratio" that even their most sophisticated theories say governments should target — while the most popular empirical studies were later debunked for having simple Excel errors.

No economy has entered into a crisis as a consequence of running fiscal deficits and issuing debt — such as Treasury bills — denominated in its own currency. The rating agencies and international institutions unnecessarily raise a red flag when the ratio of public debt-to-GDP increases. The debt that matters is that of the private sector and that in a foreign currency. If the world economy collapses, as some predict, it will be the result of private sector debt, not public.

Related to the above, a perennial complaint is that interest payments on debt represent a significant portion of the national budget. These pesos, some claim, could be used more productively. This complaint shows significant lack of understanding.

Follow this example: the government spends, say, P1,000 on infrastructure (a payment that goes to a company in the private sector) and collects only P500 in taxes. The difference is the fiscal deficit. Second, Treasury and the BSP offer the private sector (through the primary dealers) a great deal: the excess P500 — money that entered the

economy through government spending — is swapped for a piece of paper called a Treasury bill, which is willingly purchased because the sovereign Treasury of the Philippines is expected to repay (zero default risk unless this is a political decision) the principal P500 with interest of, say, P25. How does Treasury pay interests on debt?

The same way as any other payment: through the BSP by creating new money. Apart from the fact that the government paid a company to build infrastructure (corruption has nothing to do with what we are explaining here), the operation provides the private sector with additional funds in the form of interest, additional disposable income. Businesspeople seem to complain about the fact that interest payments on debt are income that goes to their pockets. We rest our case.

Part III: Fiscal discipline and responsibility or nation building?

(Last of three parts)

WE END with a plea to all the sectors that believe that fiscal deficits damage the economy. While this might be true in some special circumstances, these do not apply to our economy in general. Moreover, our monetary system and overall conditions are very different from those of the 1980s. Let's abandon once-and-for-all the orthodoxy that has prevailed in the country for decades.

The business community should understand that a deficit increases the net worth of the private sector, as it receives more than it pays in taxes. Don't shoot yourself in the foot. Also understand what terms such as "debt" and "interest payments" really mean for you when you purchase T-bills. The fiscal partner can be a great partner if you understand her.

Government officials should understand the economics behind the sectoral balances, gain a holistic view of what all relevant agencies and the Bangko Sentral ng Pilipinas (BSP) do, and understand that their job is not to match spending and taxes. Bond issuance is part of it. Bond dealers in the private sector will purchase the bonds that the Treasury offers them. As a consequence, lowering the fiscal deficit to 3% of GDP is not a meaningful target as it will reduce the nation's policy space, as long as we run a current account deficit.

Finance professionals should go beyond the financial side of the economy (interest rates, exchange rates) and understand the role their sector plays when the Treasury and BSP auction T-bills, the reason why their institutions buy T-bills, and what these do on their balance sheet.

Economics journalists have a responsibility to gather, verify, and report accurate, unbiased, and timely information to the public. Tell those who watch your programs or read your newspapers that the average Filipino does not owe P130,000 to anybody.

Fellow academics must stop using models that do not correspond to reality, in particular those based on the idea that the government has a budget constraint like that of a family. The neoclassical intertemporal budget constraint framework, an accounting identity in reality, that we all learned, appears to be rational, reasonable, and consistent with development, when in practice it has been used so often in irrational, unreasonable ways that have frequently stunted growth and made existing recessions worse in many countries.

If all the above contribute, the average Filipino will have a better understanding of the state of the economy and this will be a great step toward progress.

Myths about budget deficits and debt have damaged our economy for a long time. We need a fiscal deficit because our economy does not have firms that export (we export

people instead), hence we run a current account deficit. The only way for the domestic private sector to run a surplus and to avoid a crisis, is for the government to run a deficit, like many other economies. The only solution, if we do not want to run fiscal deficits permanently, is to change the structure of our economy and try to run current account surpluses. Easier said than done.

Double-entry accounting tells us that a fiscal deficit is an increase in the net worth of the private sector. We also have to understand how governments spend and tax. Government spending is needed for nation building: this requires infrastructure, schools, hospitals, and to eradicate malnutrition, without financial returns considerations. Certainly, the government can financially afford them if they are denominated in pesos. The recent corruption case does not imply that government spending must be curtailed. What we need is better governance. Debt in pesos is just an accounting record of the Treasury bills in circulation in the hands of the private sector, and issued as an interest maintenance operation, not for government borrowing.

Unless we understand these, and use them for nation building, we will continue facing headwinds in our development quest. It is a mistake to think that developed countries waited to get basic public goods until they reached a high income.

We have shared these views with all kinds of audiences and have written about them. Many have started understanding them but they fear eating the forbidden apple. Under the standard view, policy makers, the public, the voters, authoritarians... all of them... will destroy the economy if they begin the policy design process from the point of view of a correct operational understanding, like we propose. So, to make sure nobody will ever "bite the apple," the neoclassical framework used by academics, and the textbooks written for millions of economics students, pretend that the apple does not exist. If somebody does come to understand that "the apple exists," the neoclassical response is to invoke fear (of economic consequences like hyper-inflation), or pass the knowledge off as irrelevant ("pay no attention to the man behind the curtain").

The economic argument must be understood: What is the cost of building a school, a hospital, or a flood control project? Public goods such as these cost “nothing.” They are paid for in pesos as described earlier — if the project requires foreign currency, this has to be earned or borrowed. While a government cannot be forced into default on debt in its own currency, it is true that it might be forced into a default on its foreign obligations. Public goods like these must be valued in terms of the real resources the country dedicates to building them. What are these resources? The workers, machines, and materials used. These are real resources that the nation has, possibly underutilized. The real cost of building additional infrastructure through a government-sponsored employment program is the extra consumption that formerly unemployed workers could enjoy and the extra capital equipment that the workers would use in their productive pursuits. These projects generate income and employment. This is their value. Government programs have to be appraised by how they use real resources rather than in terms of the nominal money values involved. If the government and society at large continue thinking about them as a cost, we will always be behind.

How much can the government spend? The answer is a policy choice: does the government want to eliminate poverty and malnutrition, build schools and hospitals, or does it believe in fuzzy terms like fiscal discipline? None of our arguments contradict the idea that government spending has to be judicious. We are not saying either that the national budget has to triple next year. What we argue is that fiscal responsibility must be about addressing the pressing concerns of our society (isn't this the role of the government?), then the government can use its power as the issuer of the national currency (together with the BSP) and pay for them. The private sector will certainly benefit because construction companies, for example, will be awarded contracts, again corruption aside. A currency-issuing government can have “monetary sovereignty,” though there is a spectrum. Certainly, the Philippine peso does not play the role of the US dollar (or of other reserve currencies) in the international payments system. But to claim that we cannot afford the basics is technically and morally wrong.

There are only two limits to this. One is inflation. Government spending will contribute to improving our economy and, ideally, we should move in the direction of full employment of the nation's resources. Inflation will appear then. This is a simplification but no further spending is needed. That's the time to tax. Our proposal is to bind the government deficit to outcomes like an inflation target rather than to a debt ratio value. Such a strategy would call for a smaller primary fiscal deficit (or a larger primary fiscal surplus, depending on the circumstances) if inflation were above (or projected to be above) target. Second, the economy may face bottlenecks of different kinds, for example no Philippine company is able to supply materials to build schools (a real constraint), hence they need to be imported; or lack of public sector capacity and capabilities to implement projects. These are acknowledged but they do not undermine the thesis we have developed.

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