

# THE FIFTH PILLAR OF SOUND MONEY AND CREDIT

## THE PRINCIPLE OF FISCAL POLICY

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### **A Chinese Tale**

*Once upon a time there were, in China, two great cities: Chin and Chan. They were connected by a magnificent canal. One day the Emperor sent for his chief mandarin, Ching, and said: "Look yonder". Ching opened his eyes and looked. And he saw scores of barges laden with cargo, plying between the ports of Chin and Chan. The Emperor then commanded: "We must stop that traffic, in order to increase employment in the Celestial Empire. You will have huge blocks of stone thrown into the canal to put it out of service." At first Ching did not see the point. and said: "Son of Heaven, you are making a mistake." However, the Emperor's mind was made up, and he said: "Ching. do as you are bid. We are going to stimulate the economy. You come back after three moons have passed, and take another look."*

*When he came back. the Emperor said: "Look yonder." As he looked. Ching saw thousands of carts and innumerable pedestrians carrying heavy burdens on their shoulders, as they were making their way from Chin to Chan, and from Chan to Chin. They looked like a swarm of migrating ants. The Emperor declared: "It was the destruction of the canal that provided jobs for these poor people. We shall make it public policy to stimulate the economy by all available means." Chin remarked in admiration: "I*

*should have never thought that the government could create so many jobs so quickly and so easily."*

*When the Emperor died, his successor sent for Ching and ordered him to have the canal reopened. Ching prostrated himself nine times and said to the new Emperor: "Son of Heaven, you are making a mistake." But the Emperor was adamant: "Do as you are bid. We must facilitate the movement of people and goods between Chin and Chan, by making transportation less expensive. Then the people may have rice, tea, and silk at a lower cost." Ching thought he was ready with the answer: "But what is the use of lower prices, if no one can pay them, because everyone is unemployed?" The Emperor was losing his patience: "Ching, you are talking like a fool. Come back after three moons have passed, and take another look."*

*When Ching came back, the Emperor said: "Look yonder." Ching looked and saw more traffic in the canal than anybody had ever seen before. The barges were moving day and night, bumper to bumper, there was no hint of unemployment. The Emperor dismissed Ching with these words: "You can divert and displace labor, but you can never create new employment by erecting obstacles. Remember the wisdom of the old sages, that the secret of good government is to leave people alone."*

### **Quality of credit**

The sole aim of fiscal policy is to keep the credit of the government at the highest possible level and above all suspicion. This principle implies that the government borrows only if it can see the revenues which, in the years coming, will be available to retire the debt. If this principle is respected, then the rate of interest will be stable, and it will be the lowest possible rate consistent with economic conditions. Otherwise, the rate of interest will be higher and unstable. Moreover, the rise and instability will be commensurate with the extent to which this principle has been compromised. This will make it difficult for some and impossible for other private producers of wealth, to reinforce their enterprise by borrowing.

The quality of credit in a country cannot be higher than that of the government. Therefore, the deterioration of the government's credit adversely affects every single producer in the country.

The canal carrying the trade between Chin and Chan symbolizes a national economy that respects the principle of fiscal policy. By deviating from this principle, the government puts the canal out of service. The blocks of stone symbolize the higher rate of interest which private producers of wealth pay after all the borrowing needs of the government are satisfied. This would not stifle the national economy but would certainly render it more inefficient. A dilution of the principle of fiscal policy is usually couched in a language which would appeal to those susceptible to demagoguery. Deficit spending is called "priming the pump," "an essential stimulus to the economy," indispensable to the maintenance of full employment. Yet it is clear that the stimulus of deficit spending is at best dubious in the short run, and completely absent in the long run. The short-term

effects have the nature of prestidigitation, as government spending can be targeted to pockets of slow economic activity in order to produce spectacular results. It is the long-run effects where the damage to the economy becomes visible.

### **Accumulation of public debt versus accumulation of capital**

The accumulation of public debt is a convenient trick through which a temporary semblance of prosperity may be achieved. In the long run, however, this policy will only aggravate the situation, as it harms the economy by weakening productive capacity. The longer the government succeeds in maintaining false prosperity by increasing public debt, the greater the ultimate damage.

Mainstream economists ridicule this concern about the negative effects of the rising public debt on future economic growth. There is no way - so the argument goes - to shift the economic burden to future generations. You can only consume what has been produced. Under these circumstances, how can a nation live beyond its means? This argument is designed to appeal to simpletons. The basis for all economic growth, rising real per capita income, increased production and consumption, is the result of entrepreneurs investing their own and other people's funds in more and better tools, which permits a steady increase in man-hour productivity. Economic growth, and a rising standard of living, are ultimately dependent upon uninhibited capital accumulation.

Capital accumulation, however, is not an automatic process regulated by mother nature. To produce capital goods - factories and machinery - a corresponding amount of productive facilities must be released from other employment. It is not enough that technology and know-how is available to create new factories and modern machinery. Investors and businessmen must be willing to accumulate capital by doing the necessary investing. Furthermore, the creation of credit must not be confused with capital accumulation. People see idle factories and wonder why they cannot be used to produce the much-needed goods, with the aid of easier credit, if necessary. They fail to understand that the plants have become obsolete because adequate reserves were not set aside for depreciation and replacement. Or, if it is a new plant, people fail to understand that its construction in the first place was based on a miscalculation due to the false signal of easy credit. Rising costs have made a profitable operation impossible. People find it hard to see the thin edge of the wedge between capital accumulation and capital decumulation.

Capital decumulation, therefore, is the result of government action, such as the departure from the principle of fiscal policy. As the government creates more money and credit through deficit spending, prices and wages rise. Operating costs tend to rise faster than revenues, thus reducing profits. The result is idle factories and idle men. In short, the effect of deficit spending is more of the same condition that it was supposed to eliminate in the first place. Thus a vicious circle is put into place: deficit spending creates idle capacity and unemployment, which then call for more deficit spending, to create still more idle capacity and more unemployment.

**Kick the garbage upstairs**

There are those economists who suggest that the process of deficit spending can continue indefinitely. According to them, the public debt need never be repaid. It can go on growing indefinitely as long as a stable relationship between the debt and the gross national product is maintained. In the Ninth Pillar we shall see why this is a fallacy. Here we may content ourselves with the observation that accumulating debt at the expense of accumulating capital is like dumping garbage in the attic. At one point, the attic is bound to give way and all the garbage will come crashing down.