

Czego uczy nas historia gospodarcza?

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State budget: what is it and how is it constructed?

Prof. Paweł Grata and Prof. Wojciech Morawski discuss.

Paweł Grata: Good afternoon. Welcome to another meeting in the series "What does economic history teach us? 12 Conversations for tough times", carried out as part of the project under the same title, funded by the Ministry of Science and Higher Education as part of The Social Responsibility of Science programme. Today's guest is Professor Wojciech Morawski from the Warsaw School of Economics. We will talk with the Professor about the state budget, which is something that attracts the interest of the whole society, because the budget is money. Money that perhaps comes to us. Professor, what is the state budget? Perhaps we should start by explaining the concept and then talk about how the state budget has evolved.

Wojciech Morawski: The state budget is a statement of income and expenditure in the kind of arrangement that emerged in accounting at the end of the Middle Ages, i.e. double-entry bookkeeping - "owed and owed". And it should simply balance more or less. It has been stated that it is better if there is such a thing, especially it has been stated since it has been recognised that this is a political matter. That is - but if the executive is accountable to the people, it is accountable, among other things, for how it manages money, and it should be able to show that in a clear way. For a long time, the main expenditure in budgets was war. The state's expenditure was primarily military. And some taxes had to be collected to pay for the war. In the 18th century, the states were in debt and this was a problem, because the states could not cope with servicing this debt. When it came to debt servicing, the English had quite a few good ideas in the 18th century in this area. First of all, they consolidated all, it wasn't individual loans with different interest rates, but they made such a consolidated national debt. What's more, they created something like perpetual bonds, meaning you didn't have to repay the loan until the end, you could exchange the loan for a new generation of bonds and simply treat these bonds as a capital investment. There was an interest rate on these bonds and you could operate in such a way that instead of landed property, I simply had £10,000 at 3 per cent, which gave me £300 a year, and with £300 a year, you were already wealthy and could live quite well off it in the 19th century. Then in the 19th century we have the liberal state. Generally, the liberal state does not particularly want to interfere in the economy. The liberal state deals with foreign policy, the judiciary, the police, the army of course. Since there isn't a lot of that, but there is a little bit of that, there has to be some tax collection for that, so there will be some sort of Treasury that collects for that. But, for example, whether there should be a separate Ministry of Health, whether there should be a separate Ministry of Education, the Liberals have already pondered. They have generally concluded in the end

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that there should be. Firstly in education it should, it is in the general interest that the poor should also be educated. It should not just be the market. And it is also in the general interest that the poor should also be treated. Or, for example, vaccinated. For general health, it should not be purely market-based. Imagine a situation where, for example, there is an epidemic and it has to be done, this is not taken care of by the market, only the state with its instruments can do such a thing. But this was more or less the end of the budgets of liberal states. At the end of the 19th century, some new elements appeared, they appeared in Germany first. Towards the end of his reign, that is in the 1880s, when Bismarck was Chancellor of Germany and the Social Democratic Party (SPD) was growing in strength, Bismarck decided that he was going to fight them. Except that he intended to fight them not stupidly, that is, not by repressing them or banning them or something, but wisely. He decided that the state itself should conduct such a policy that the workers would recognise that the state could take care of them and that socialists were not needed at all. This was called socialism from the cathedral. As part of this, social legislation began to be expanded, the pension system created by Bismarck, health insurance. The state started to enter such fields, then others started to imitate the Germans in this. The Germans were the pioneers of these things for sure. Then came the First World War. The First World War was monstrously expensive, and in fact everyone came out of that war terribly indebted and settling those debts was beyond their means. In fact, the financial consequences of the First World War wrecked the economy. There was an attempt to go back to something like the 19th century, but it just didn't work anymore. That it could not be done was made clear during the Great Depression of the 1930s, when it became clear that there was no going back to a liberal economic policy. The state has certain obligations, concerning the stimulation of the economy, concerning precisely the social care of people. The state cannot tolerate people dying of hunger. If a state is prosperous and people are dying of hunger in its territory, it means that this state is badly governed and should do something about it. This called for a transformation in economic policy. There was a break with this liberal doctrine that we should not interfere. The budget should be sufficient for this, and that means that this budget should be financed in a different way than before. The demand that this budget be balanced has ceased. It was reconciled to the idea that it would run a deficit.

Because it was an important principle of liberal economics that the budget had to be balanced.

In the long term, it may have happened that we have a deficit in some year, but it is in the next year that we should make up for it. And here we are accepting that we will permanently have a deficit. At the same time, the monetary system was changed. From now on, the cover for the issue of money was not the gold stock, but precisely the national



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debt. And this meant that we set in motion a slow inflation. However, to ensure that this inflation does not get completely out of control, certain brakes have to be put on it. A brake appeared, for example, in the form of a rigid relationship of some kind between national debt and national income. It was then that such a category appeared, and then GDP began to be calculated. Before that, simpler indicators such as industrial production or something like that were used. GDP is an integrated indicator that reflects the situation in the whole economy, and the debt should be in a certain proportion to GDP. Of course, the debt will grow from year to year. If we have a deficit every year, the debt will grow. But if we have GDP growing at the same time, then we have a chance to keep that ratio as more or less rigid. That's what Keynesian economics was about in this area. During the Second World War, two new things happened. Firstly, war debt was much better managed. After the experience of World War I, one knew how to handle it. For example, there was the emergence of something like the Lend Lease, the kind of aid to the Allies that did not generate international debt. The Americans learned how to help the allies in such a way that at the end of the war the allies wouldn't be owed full of money, because firstly they wouldn't give it back anyway, and secondly there would only be trouble from it. That's what the Americans have learned so much already. Secondly, during the Second World War, there were ideas that after the war the social interests, the people's sense of social security, should be taken care of much better. In 1942 there was such a top-secret document prepared in the British government, it was called the Beveridge Report, and it was such a welfare state programme for the war. Interestingly, this Beveridge Report, translated into German in one copy, Hitler had in his personal library and studied it carefully. Well, and after the war, when the Labourites won the election in Britain in 1945, the English began to put this into practice on a large scale. That is to say, there was the emergence of a health service that was free to the people, funded from the budget. Many sectors of the economy were nationalised. Not like the communists, that everything was nationalised, but a lot of things were nationalised. And generally this whole state sector grew a lot in relation to national income. By the way, one measure of economic freedom today is the proportion between national income and what passes through the budget. The state can be either more restrained or more profligate in this matter. The welfare state worked quite well until the late 1960s and early 1970s, when it became apparent that it was all too much and the inflation generated by the system was too high. The effect of this, and I am speaking in simplistic terms, because of course there were other causes, but the effect of this was the oil crises and there was a monetarist turn in economic policy. That is, Keynesianism, whose main goal was full employment, the goal of Keynesian economic policy was full employment, that is, that there should be no unemployment. The Keynesians knew that this was at the expense of inflation and they condoned inflation as long as you had full employment. There was even such a Philips curve, which showed



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the interdependence between inflation and unemployment, and it was such a hyperbole, I think it's called something like that. And it worked nicely up to a certain point, but now it has stopped working, that is, it has turned out that this inflation is getting out of control, it has assumed such proportions that it no longer helps the economy, but begins to harm it. Under the influence of this came the monetarist turn, that is to say a policy, symbolised in Britain by Mrs Thatcher, in the United States by Ronald Reagan, which made inflation its number one enemy. And above all it fought inflation, even at the cost of higher unemployment. Under the influence of success, because after all, this monetary turn brought the world out of the severe crisis of the 1970s and made it prosperous again. Under the influence of this success, it spread around the world. And in fact in the 1990s it was treated everywhere in the world as a dogma so self-evident. It was called, not very deftly, the Washington Consensus. The awkwardness lay in the fact that this Washington in name looked like such an American absolute dictate. The Americans didn't particularly want this, but they got themselves into such an awkward situation. The disadvantages of this started to become apparent as early as the second half of the 1990s. There was the Asian crisis in 1997, when it became apparent for the first time that this Washington consensus was not quite working. That is to say, the Monetary Fund was recommending to various countries to act according to this way of thinking, and this only made their troubles worse. And there was one country that said this is nonsense and we know better how to do it. That was Malaysia. And Malaysia was the first to get out of the crisis. And it was such a lesson that it's not such a once and for all prescription, that it can be questioned. Well, and then 2008 brought such a shift in that liberal thinking. In fact, it should have been a triumph of Keynesianism. There were books that announced that now at last Keynesianism had proved that it had always been right, it had just been pushed down wrongly. But it turned out pretty quickly that this was not true. That is, Keynesianism, with its various virtues, undoubtedly has the weakness that it treats natural resources as inexhaustible. Keynesianism believes that we need to increase production to ensure full employment, and if we devastate the environment in the process, we don't care. Keynesians were not enemies of ecology, as right-wing politicians tend to be. The Keynesians ignored it, but that means they had a weak point here, which is why they didn't triumph, but they are also in trouble today and nobody actually knows what to do about it.

These recent events: both the 2008-2009 crisis and the COVID time are periods when budget deficits are again, very clearly, often increasing. How can this process, this phenomenon, be assessed?

During the 2008 crisis, the Americans were the first to use something like fiscal easing, that is to say they called it *helicopter money*, that is to say they simply pounded money



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into the economy just like that, with no special controls and no special limits, just to save it. Here, from this point of view, there are three countries, three groups of countries that behaved a little differently. The Americans were the boldest in this, the Europeans were the most restrained. The European Central Bank was very afraid of inflation, because the euro was created at a time when monetarism was triumphant and the euro is primarily anti-inflationary in such thinking. In the middle between one and the other was the Bank of England. The Bank of England followed a more or less middle path. And the results were, the Americans got out of the crisis most easily, the English worse, Europe worst. That is, the lesson was that generosity pays off. In such truly threatening moments, generosity pays off and there is no need to fear inflation. Of course inflation has its disadvantages, it has its negative social effects, but the negative social effects of what the absence of inflation gives us may be worse.

Here we have the example of the Great Depression of the 1930s, when there was no inflation and indeed the biggest crisis in history. But it is also worth remembering that there were countries that paid heavily for generosity in the post-2009 period.

As we say that the Americans have behaved coolly, let us take one correction. The Americans have it easier in this respect because the dollar acts as the world currency. When the Americans increase dollar issuance, they know straight away that only a fraction of these dollars will stay in their market and feed their inflation, and the rest will go out into the world and they will never see it again in their lives and may not care about it at all. No one else has that luxury. They would like others to have it, they aspire to it, but for the moment they do not have it. The Greek example was so extreme, because the others, the Italians, the Spaniards, the Portuguese, they somehow got their act together. Greece, on the other hand, did indeed pull itself together, but with a lot of international help. And in fact, the only reason it did so was because they were in the eurozone. Their failure would have been the failure of the eurozone. If they had had their own drachma, the rest of Europe would have waved them off.

That's right, the eurozone, as you mentioned, created during the period of monetarism, the dominance of monetarism, assumes, after all, rigid ratios of budget deficit to GDP, of public debt to GDP.

Well, yes, but it is all just such monetarist orthodoxy, a bit out of this era. Today it doesn't really fit with reality anymore.

Yes, because we know countries where public debt exceeds GDP and somehow they continue to function. And please also tell us, very generally of course, how this share of the budget in GDP has changed numerically. What we were talking about earlier,



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that depending on how restrained the state is or is not, more or less of the national income takes over and flows through this budget. How does this shape up in percentage terms?

The trouble is that for the times when there was a really liberal economic policy, i.e. for those of the 19th century, we don't have GDP, because it wasn't counted then. There are such backward calculations of GDP, but I am sceptical about such accounts, so we don't have such elegant comparisons. Well, and then it started to be more than half simply. Of course, that developed in the Keynesian era and then rolled off in the monetarist era. Monetarism was accompanied by such a process, which was called deregulation, and it consisted of the state withdrawing from various direct economic activities. And something that was state-owned was being privatised, something that was regulated by the state started to be unregulated. This was not always a good thing. Sometimes, for example, when the British privatised the railways and then lowered the regulatory standards even further, they had a whole series of rail disasters. It's not such simple things that surely going one way is right in every respect. It's something for something always.

Coming back to the deficit, the deficit is always the public debt. And now the need to finance it. It is most often financed by bonds, with the fact that the price of bonds is heavily influenced by both the make of the economy and the ratings. How would one assess the impact of these international financial institutions on the budgetary situation of individual countries?

These institutions are not objective, these institutions are entangled and have their own interests, and this became very clear in 2008 when they simply got it wrong, collectively got it wrong. These are institutions that assess credibility, but before that they themselves, for example, prepare the data for this assessment and it's such a bit of a closed circle and it's subject to corruption, I would say. But of course the prestige of the economy matters. Please note another aspect of this. The more we expand the state sector, the more temptation we create, for political corruption, right? There are those state-owned companies where we locate colleagues and so on. The smaller the state sector is, the less this temptation is, because in the private sector to locate colleagues is already a different art, so to speak, and more rational perhaps. So there is a link between the expansion of the state sector and the quality of democracy, one can say that with certainty.

Yes and also expanding the state sector, i.e. expanding the budget, means less money for private investment.



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Well this sector, well the private sector certainly is, whereas the state sector can invest.

Except that even Keynes was against state investment.

No, well, yes. We are talking about state interference in the economy, it is clearly worth separating such two phenomena. Firstly, a state that pursues an active economic policy to screw up the economy and a state that steps into the role of landlord, i.e. statism. The United States is a classic country where there is large-scale interventionism, but no statism. State-owned companies in the States are really not many, it is really a private economy. It's just that poorer countries, on the other hand, have this dilemma that they don't have these capital resources. And they face the dilemma that either the state is going to do it or nobody is going to do it. Well then there is a temptation to expand the sector.

One last question relating to the current international situation and how countries' budgets and the structure of budget expenditure are evolving in the situation we have in the world today.

At the moment we are in such a war time that war budgets are in unlimited expansion. This is going to sound cynical, but imagine that suddenly the war in Ukraine ends, then we have an economic crisis. Sorry to put it so brutally, but this is the truth. Armaments screw up the economy. If you study the history of crises, it is usually the end of a war that is the crisis, well, because suddenly all those emergency orders from the war end. Everybody catches their head that they are very much in debt, they start reducing spending, mainly armaments, and the economy goes into crisis, this is normal. I don't mean to say that wars should continue indefinitely to avoid a crisis. But that is exactly how it is with economics. It is always something for something. It is not the case that some solution has only advantages or has only disadvantages. It is such an interconnected system, where you pay something for something.

An example of a budget deficit. It has its advantages, it has its disadvantages and it has its costs, which we have to pay at some point. And indeed, however, armaments expenditure is budget expenditure. That is to say, the budget is driving the economy today via arms expenditure. Exactly as in Poland in the 1930s, for example.

In general, the global economic situation at the moment is very good, after all. People tend to see things that are bad, so people see the dangers, the disadvantages of that, but the economic situation at the moment is excellent, it hasn't been so good for a long time.

And that is something to be happy about, Professor.

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Well, yes.

Although to be cautious at all times when it comes to the budget deficit.

In the midst of all sorts of bad things, if there is something to be happy about, let's rejoice.

The budget issue itself, on the other hand, will always seem to have two different sides to it. The more we spend, the better for the economy, but the more we spend from the budget, the less we will spend from our pockets. We will probably have less in those pockets.

One more thing perhaps to add, because we have forgotten a bit about all this, but the issue of the budget is an issue in parliamentary systems, it is one to which trust in the government is attached. That is why, for example, the president cannot refuse to sign the budget if the Sejm passes it. The Senate cannot tinker with the budget, because the government's responsibility is to the Sejm, not to the Senate, and so on. There are various systemic considerations of the budget, so to speak, which are also worth bearing in mind.

And the budget, however, is an expression of government policy, of the government that is running the country at any given time.

The most important law the government must have. There are no jokes here.

And the most reliable evidence of government sweep, because here money determines what the government will do. Thank you very much, Professor.

Thank you very much.

This was another talk in the series 'What does economic history teach us? 12 Conversations for Difficult Times' as part of a project under the Social Responsibility of Science programme. Thank you to.



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