Internal Imbalances, State Finance and the Global Recovery

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Twenty-twelve is a year of political leadership transitions for many countries. While politicians in the West are fiercely trying to win national elections and debating issues of tax adjustment, debt reduction and welfare reform to save broken budgets and boost sluggish economies, China's leaders also have similar issues on the political agenda in order to narrow income inequality and spur consumption demand of the lower and middle class. Among the many initiatives proposed, the most important policy measure is how to recast social welfare services along with their financing. Indeed, it is the focal issue faced by current and future governments in the post-crisis era, since it will determine, to a large extent, whether the global recovery is sustainable or temporary, and whether the crisis will resurge or be tamed.

Due to the fact that markets are imperfect and agents have short-term outlooks, it is crucial for governments worldwide to be allocating resources for social welfare services in periods of uncertainty over the long term. Even though state-funded welfare services vary widely across countries, they normally cover a wide range of areas, including health care insurance, retirement benefits, housing programs, poverty subsidies, etc.

Conceptually, we use "state finance" or "broadly-defined public finance" to define the public sector's involvement, participation and intervention in financial markets to fund social services over a very long-term period.[1] It is different from "narrowly-defined public finance" which focuses on the balance sheets of matching government budget sources and expenses in a fiscal year. For the time being, the core challenge for world leaders can be boiled down to reform of state finance so as to align domestic imbalances and to resume a sustainable global recovery.

Internal Imbalances in the West

During the last few decades, the public sectors in OECD countries have proliferated significantly. In recent years, an overwhelming number of European Union countries have further raised their public spending relative to GDP. As a consequence, Europe's social democratic model has led to widespread cradle-to-grave entitlements, with the public sector accounting for 40 percent of the Euro bloc's GDP and gross sovereign debt over 85 percent of GDP. Even in America's Anglo-Saxon model of capitalism, publicly-funded social welfare amounts to an astonishing size for which health care spending claims a quarter of the federal budget and almost all mortgages are either guaranteed by government-sponsored enterprises or provided by the federal government.

This reflects the dual characteristics of modern capitalism, which integrates two sectors of the real economy—a "productivity-generating market sector" and a "low-productivity state-funded social services sector".[2] In addition, there is an accommodating financial sector which consists of three partitions: the first is commercial finance to support the productive market sector, the second is state finance to fund social welfare services, and the third is hedge finance to engage in arbitrage and speculation against underlying assets from these sectors.

Nevertheless, the overexpansion of social welfare will build up welfare statism, which in turn suffocates the competitive and productive market sector.

This internal imbalance on both sides of the Atlantic is, if not a dominating reason, at least one of the major causes of the recent global economic woes. The prevailing social welfare state in many western countries is proving to be unsustainable and must be tailored in scale and scope to fit affordable state finance. The global recovery relies heavily on the direction of how internal imbalances are aligned. But there exists a "phase locking" in western countries to correct the collective irresponsibility of state-financed social welfare programs. This problem originated from the deficiencies of the political structures in these countries.

In the United States, the most serious problem of public governance is political polarization in the policymaking arena between the Republicans and Democrats. This polarization paralyzes domestic economic policy decisions, especially on issues around public finance such as deficit reduction, tax increases, health care reform, spending priorities, etc. In comparison to their predecessors a few decades ago, there is a shrinking overlap between the representatives of the two political parties in Congress.[3] This echoes deep social mistrust and a growing political divide in American society, which has increased in recent years and is restricting lawmakers and the administration in reforming welfare and state finance matters on a neutral, bipartisan, long-term and fiscally responsible basis.

As the U.S. political machine grinds to a halt, the Federal Reserve has gone astray from its long-standing independent position as the guardian of price stability and zealously engaged in the unconventional easing of monetary policy since the global financial crisis. In the name of restoring financial stability, the Fed has not only shouldered enormous mortgage-backed securities and Treasury debts to release prolonged liquidity for the housing sector and the government, but it has also depressed interest rates to very low levels in order to nurture them. Congressman Paul Ryan, chairman of the U.S. House Budget Committee, said that "the Federal Reserve is sort of bailing out fiscal policy because the branch of government in charge of fiscal policy is not doing its job".[4]

Yet there is no panacea for the problems currently being faced and the Federal Reserve's proactive easing of monetary policy to save fiscal distress has destructive consequences. It is obvious that such unconventional policy action may lead to additional uncertainty, which could prevent entrepreneurs in the productive market sector from committing investments, even though the Federal Reserve is using this policy to spur economic recovery and employment. Even worse, this practice is detrimental to the trust in the Fed's commitment to its obligations, which is a cornerstone of market capitalism. The Federal Reserve must honor its obligations (or implicit contracts) with the rest world not merely in nominal terms but also in real terms in order to safeguard the international financial markets' trust in the U.S. dollar. This contract must be accountable and irrevocable in all matters. To deliberately dilute the unit purchasing power of the U.S. dollar is equivalent to stealing wealth from its creditors both at home and abroad. This would result in a destruction of confidence in global markets. In fact, today's cure will turn out to be tomorrow's demise. For example, currently international investors that buy Treasury bonds are subsidizing the U.S. government by accepting negative real rates of returns. However, this trend could be reversed if they lose confidence in either the stability of the greenback's value or the ability of the U.S. government to address its budget deficit.

On the other hand, in the EU, the real trouble is neither a lack of a fiscal union nor a political union. Rather, it is the fault of social democratic politics, which created an over-entrenchment of the social welfare state through an overdrawing on the future. In short, the uncompromising beneficiaries of social welfare—including entitlement holders, labor unions, public sector employees and other vested interests—formed unbreakable alliances to resist the restructuring of financially unsustainable social welfare states in Europe. When backlash against reforming the social welfare state became too strong to be settled in short run, the European Central Bank departed from its sole mandate of price stability and moved to save Europe's sovereign debt woes by injecting liquidity into the region's

banking system. However, this act only shifts the burden from creditors to debtors and from the present generation to the next. In fact, there is no way to save the broken social welfare programs in Europe without ideological and behavioral change of politicians and citizens alike, especially in the struggling peripheral European countries.

Internal Imbalance in China

While the provision of social welfare has overtaken the productive market in the West, China's imbalance is characterized by the underdevelopment of the social welfare services sector coupled with dominance of state-owned enterprises in the lucrative market sector. This internal imbalance is a critical source of income inequality and social resentment in China.

However, the Chinese government has recently realized this issue and has begun addressing it in order to lessen the income gap and promote domestic demand. For example, China is launching campaigns to revamp its welfare programs, including impressive initiatives like health care insurance for rural residents and the urban poor, and a housing program for low-income households in urban areas.

Contrary to the fiscal pinch in western countries, the Chinese government is well positioned in this regard. This is due partially to the government coffer, filled by China's phenomenal economic growth, and partially to the large role of state finance in the country's financial sector. Therefore, the problem of rebalancing China's real economy is not a lack of financial ability, but rather the political framework and the governance status quo regarding the ways of mobilizing and allocating resources via state finance with Chinese characteristics.

In China's prevailing unitary structure, the allocation of state-funded public resources is basically in accordance to a hierarchical pecking order. Under this framework, the provision process is opaque, discretionary and skewed toward related power groups. This feature is more likely to create a divergence in social welfare services, especially in health care insurance between different people and different regions in the country. If this problem is not properly tackled, the government's efforts to improve social justice will be eventually undermined.

Restructuring social welfare in China forces the government to mobilize enormous resources via state finance to fund welfare provisions to citizens over generations. However, under the current state of the country's public governance structure, Chinese authorities may fall into a path-dependence trap by resorting to conventional methods such as politicalized mobilization, administrative decree, mass-movement campaigns, and etc to serve the end goal. This could produce severe negative consequences for the viability of state finance to support social welfare services in the future. For example, there could be an agency problem between the central government and the localities, for which the latter would be too lenient in supplying services in order to fulfill short-term political goals, leaving a pileup of financial obligations for the central government to bail out. Another problem is moral hazard initiated from bureaucrats, who take advantage of their administrative power to seek unlawful income or nurture their inner circle at the expense of ordinary people. Eventually, these consequences would result in heavy financial burdens for the state.

The Challenge Faced

Since the end of 2008, the macroeconomic policies for stimulating aggregate demand and lessening global imbalances have shown limited effect in advancing the world economy, although they may have prevented it from free-falling into an abyss. In the post-crisis era, advanced countries should rebalance their domestic economies, especially by reforming their social welfare programs.

Yet it is not a pure economic but rather social and political matter which confines the resiliency of the global economic recovery. In all respects, there are three urgent questions must be addressed: the first is what would be an "appropriate size" of the social services sector against particulars of a country? The

second is how could governments reform it in line with the optimal level? The third is how might it be financed efficiently in the long term? These questions have still not been properly answered.

The pending threat for the global recovery is unsettled political economy issues, particularly the polarization of U.S. policymakers and the uncompromising resistance of European welfare beneficiaries which have resulted in inaction in reforming social services in line with fiscal realities. As such, central banks have been forced to cross the boundary of independence by printing money explicitly or implicitly to save national budgets and to support state finance. However, this is a self-destructive policy, which will hurt the trust in the global market system. It is high time for us to refresh what Keynes warned in 1919, almost a century ago: "Lenin is said to have declared that the best way to destroy the capitalist system was to debauch its currency... Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency."[5]

To tackle the challenge, major countries need to reform their respective political structures regarding the allocation of public resources for social welfare. In the West, all stakeholders and political leaders must work together in a constructive way to solve the knot of disagreement between different interests and properly balance the interests of present and future generations. The decision-making structure also needs to be reformed for better representation in both cross-section and time-series dimensions. A possible option, for example, is to bring in interest-neutral agents in the decision-making process to represent the rights of future citizens. They should consist of a group of academics and citizens and be jointly nominated and/or appointed by administrative and legislative bodies with the goal of safeguarding the sustainability and viability of state finance for funding social welfare over the generations to come. Meanwhile, central banks must resume the ultimate duty of preserving currency values, rather than intentionally diluting the purchasing power to shift the debt burden to their local and global creditors.

In China, the main problem stems from flaws in the prevailing political framework regarding the provision of large-scale and long-term social welfare. It is very important for China to balance the development of both the productive market sector and state-funded social welfare sector in order to reach a stage of "endurable governance and long-term stability" as the Chinese proverb says. Against a backdrop of international experiences and lessons, China can learn significantly from the rest of the world. China must structure its social welfare programs in line with the rule of law, transparency and accountability. Meanwhile, it must be fully aware of the demise of the almighty government model and avoid jumping on the wagon of welfare statism in the process of rebalancing its domestic real economy.

Unless balanced development of the productive market sector and social welfare along with their appropriate financing is achieved in the major economies of the world, the global economy will not move toward a sustainable growth trajectory. This is the undeniable mission confronted by both present and future leaders, regardless of who is in power next year.

References

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Endnotes

[1] Similar to "corporate finance" or "household finance", this concept indicates that government is a subject of taking financial activities to fulfill its goal.
[2] Summers (2012).
[3] Carroll (2012).
[4] WSJ (2012).
[5] Whitson (1977).