

CAYMAN FINANCIAL REVIEW

Second Quarter 2014, Issue #35

Dollars, Euros, and Debt: How We Got into the Fiscal Crisis, and How We Get Out of It *By Vito Tanzi, Palgrave Macmillan 2013*

By: Reviewed by Richard W. Rahn
April 14, 2014

Vito Tanzi has again given us a solid economic explanation of what went wrong and why, and what can be done about it. The basic message of the book is that governments have grown too large, have spent way too much money, and have tried to get out of the mess through the inappropriate use of monetary policy rather than by drastically cutting spending. There is nothing particularly new or surprising about Tanzi's message, but, as usual, he makes his case in a quiet, logical manner with plenty of empirical analysis and solid studies to back up his arguments. In many ways, Vito Tanzi is an ideal economist. He has a solid academic background (Ph.D. in economics from Harvard) and considerable real world experience, including 27 years at the International Monetary Fund where he was director of the fiscal affairs department. He also served as Undersecretary for Economy and Finance in the Italian Government (2001-2003). He has taught at several fine universities and written many highly regarded books and articles. Unlike many economists of his generation, Tanzi has not been a prisoner of the ideological orthodoxy that prevailed when he was at Harvard.

Vito Tanzi would probably have felt intellectually at home in the company of the American founding fathers. His wide experience, like theirs, led him to believe that our goals for government should be modest. He states: "It is important for citizens to recognize that resources are always scarce, and the function of governments should be to prevent hell on earth, rather than to try to establish heaven. When the state tries to do too many things, it inevitably brings excessive complexity in its actions and becomes inefficient." F. A. Hayek and other Austrian-school economists often made a similar argument.

Mankind seems intent on repeating the same mistakes time and time again. He quotes Cicero from 43BC:

"The national budget must be balanced. The public debt must be reduced. The arrogance of the authorities must be moderated and controlled. Payments to foreign governments must be reduced if the nation does not want to go bankrupt. People must again learn to work, instead of living on public assistance."

Tanzi is a foe of public debt, though he understands that some debt is appropriate during downturns in the business cycle, provided it is paid back during more prosperous times. But what he has learned from history and his own experience of dealing with many governments is that most governments fall into the temptation of abusing it. To remind us again that nothing is new, he quotes David Hume from three centuries ago:

"The practice...of contracting debt will almost infallibly be abused in every government...Therefore...the consequences...must indeed, be one of ...two events, either the nation must destroy public credit, or public credit will destroy the nation."

Tanzi's book gives many examples of how public debt ends up being highly destructive. Yet he is not one of those who thinks the solution is higher and higher taxes. He argues that it is neither possible nor desirable to greatly increase tax revenues, and the only real solution is to cut

spending as a percentage of GDP. Tanzi argues, based again on solid evidence, that total government spending above about 35 percent of GDP becomes counterproductive. My own studies, and other studies that I have reviewed, put the number at least ten points lower – but we are all in agreement that almost all of the major governments are spending at excessive levels that depress economic growth, job creation and reduce social welfare.

Tanzi has no problem in taking on what he considers the bogus arguments of many modern day Keynesian economists.

“It would truly require a ‘suspension of belief’ or total irrationality on the part of individuals to continue to assume that developments in fiscal accounts that are likely to lead to significantly higher public debt when the debt position is already high and will have no negative impacts on individuals’ propensity to consume. It is naïve to assume that developments would have only positive effects, through significant and positive multipliers, that would make economies grow fast enough to prevent the growth of the debt/GDP ratio as argued in a recent paper by DeLong and Summers.”

Tanzi also argues that much of the economic data out of governments is corrupted both through incompetence and more often political pressures to make the numbers appear better than they are. In this regard, he gives us “Goodhart’s law,” which broadly states that “when the value of a variable creates incentives for its manipulation, that variable will be manipulated.”

He spends some time giving specific examples of governments understating their true debt burdens, and explains many of the statistical and other tricks they use to deceive creditors, political opponents, and the international community.

One of Tanzi’s conclusions is that: “Fiscal crises are always more difficult to solve than financial crises, because they involve the role of many politicians and affect many more citizens.”

In support of that argument, Tanzi cites the “fundamental law of public expenditure growth” which states that “most government programs, which are created at some point in time, and which when they are created require some increase in the level of public spending (as a share of GDP), have a tendency to grow almost continuously and spontaneously, over future years and become more expensive.”

This tendency combined with Baumol’s law, “which argues that the productivity of the public sector’s activities tends to grow less rapidly than the rest of the economy,” in part explains why economies grow slower and slower as government gets bigger and bigger.

Dollars, Euros, and Debt was written for the intelligent, economically literate reader. It would be a stretch to call it a fun read. It is more like a useful reference book, in that Tanzi has clearly, accurately and precisely laid out many of the key arguments and facts in the debate about taxes, spending and debt.

If you are going to debate current economic policy before an audience or just with friends – read this book. It may well keep you from sounding foolish or ill-informed.

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