Introduction

This work examines three centuries of the most prominent political-economic theories of public debt, to help illuminate various causes and consequences of the unprecedented expansion of such debt over the past decade and – as is probable – for decades to come. I consult and interrogate not only specialists in public debt but also the most influential minds of political economy in modern history, from Hume and Smith in the eighteenth century to Ricardo and Marx in the nineteenth century, to Keynes and Buchanan in the twentieth century.

That public debt has undergone “unprecedented expansion” of late reflects two facts. First, until recently, public debts were typically incurred during wartime, not in peacetime. Second, unlike today, large debt burdens in the past were usually felt most by less developed nations, not advanced or industrialized nations. Evidence is abundant that these new patterns are attributable largely to the spread of ever-more democratic, fiscally profligate welfare states that expand social insurance and pension schemes without overtaxing voting majorities,¹ and also to state guarantees of fragile financial sectors,² which promote excessive risk-taking (“moral hazard”) while necessitating periodic public absorptions of defaulted private debts.³ Equally unprecedented (and reckless) is the recent adoption of zero or negative interest rate policies by major central banks, which help highly leveraged sovereigns borrow at artificially low rates, and enable still more public borrowing and ever-rising rates of public leverage.

The great American statesman and finance minister Alexander Hamilton (1795) was the first to identify the relationship between unrestrained democracy (with purely “popular” instead of constitutional government) and unmitigated growth in public debt:

[There is a] danger to every Government from the progressive accumulation of Debt. A tendency to it is perhaps the natural disease of all Governments and it is not easy to conceive anything more likely than this to lead to great and convulsive revolutions of Empire. . . There is a general propensity in those who administer the affairs of a government, founded in the Constitution of man, to shift off the burden from the present to a future day; a propensity which may be expected to be strong in proportion as the form of the State is popular.

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Four decades later, writing in *Democracy in America*, Alexis de Tocqueville (1835, p. 196) noted that when “the people is invested with the supreme authority, the perpetual sense of their own miseries impels the rulers of society to seek for perpetual ameliorations,” and “those changes which are accompanied with considerable expense are more especially advocated, since the object is to render the condition of the poor more tolerable, who cannot pay for themselves.” Moreover, “democratic communities are agitated by an ill-defined excitement and by a kind of feverish impatience, that engender a multitude of innovations, almost all of which are attended with expense.” The populace soon “discovers a multitude of wants to which it had not before been subject, and to satisfy these exigencies recourse must be had to the coffers of the State.” Ultimately, for Tocqueville, the cause “which frequently renders a democratic government dearer than any other is, that a democracy does not always succeed in moderating its expenditure, because it does not understand the art of being economical. As the designs which it entertains are frequently changed, and the agents of those designs are still more frequently removed, its undertakings are often ill conducted or left unfinished” such that “the State spends sums out of all proportion to the end which it proposes to accomplish,” even as “the expense itself is unprofitable” (pp. 196–7).

Hamilton and Tocqueville, being equally suspicious of unrestrained democracy, were also prescient about its deleterious fiscal effects. It’s become a commonplace in modern (unrestrained) democracies in the past century that governments have extracted and spent ever-higher shares of private income, and while some political parties secure votes by promising higher public spending without more taxing, others secure votes by promising lower taxing without less spending. The result: an inherent bias in favor of chronic deficit spending and public debt accumulation. According to Gersbach (2014):

> Limiting the accumulation of public debt in democracies has always been a problem but it has become a particularly pressing one in the last few decades. . . [Democratic] political processes tend to push public debt to levels that are likely to be socially undesirable. The reasons for this tendency are well known and well explored: fragmented governments, political uncertainty, time-inconsistent public debt policies, rent-seeking and increasing the advantages of incumbency – to say nothing of shifting the burden of public debt onto future generations – can all lead to excessive debt accumulation.

The past two decades entail an astonishing reversal of fortune in the public debts of democracies. When this century began, most major nations, including the United States, were enjoying consecutive years of budget surpluses, debating about the likely duration of surpluses, and about how much public debts might decline without harm to policymaking
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or markets. In 2000 the US Treasury submitted a draft chapter for the *Economic Report of the President*, which analyzed the presumed dilemma of a pending disappearance of US public debt; it was discarded when surpluses began to vanish.\(^5\)

Today, opposite concerns prevail. The United States and major nations now run record budget deficits, and are likely to do so for decades to come, amid rising public leverage ratios that now approach levels last seen in World War II. Major central banks now monetize vast sums of public debt and vow to keep short-term interest rates near zero indefinitely. Previously unquestioned sovereign debtors, the United States included, have lost their top debt ratings. The (seeming) paradox is that as public leverage ratios have climbed in recent decades, public bonds yields have plunged, explicable partly by the resumption of the autocratic wartime policy of “financial repression.”\(^5\) Central bank “independence” from politics, once seen as crucial to monetary integrity, has given way to the phenomenon of “fiscal dominance” of central banks by highly leveraged sovereigns.\(^6\) Record low public debt yields imply that sophisticated bondholders reject debt pessimists’ fears of a looming financial disaster and inevitable economic collapse; meanwhile, the debt optimists, who insist that deficit spending “stimulates” economies, can’t explain why those receiving the most stimulus (Japan, United States) suffer persistent economic stagnation.

There’s no better time than now to re-examine public debt history, theory, and practice. The main purpose of this work is to convey and critique the rich history of political-economic theorizing on public debt across three distinct schools of thought: classical, Keynesian, and public choice. Each school seeks to explain the evolution of public debt, its political-economic causes and effects, the meaning of sustainability in debt burdens, and the conditions under which governments are likely to monetize or repudiate their debts. For empirical context, I begin with three centuries of data on public debt for major nations, relative to national income, and government bond yield data for more recent decades. Throughout, I also examine various methods for assessing fiscal capacity, debt sustainability, and the outer limits of government borrowing. The empirics provide a concrete basis for assessing the validity of public debt theories.

Clarity of exposition is enhanced, I believe, by a tripartite classification of the major theorists of public debt since the early 1700s. Beyond the usual “schools” of thought on public debt, I classify debt theorists as pessimists, optimists, and realists. For reader convenience I provide an Appendix, which aptly groups the major thinkers.

Public debt pessimists typically argue that government provides no truly productive services; that taxing and public borrowing detract from the private economy, while unfairly burdening future generations; that high
and rising public leverage ratios are unsustainable and will likely bring national insolvency and perpetual economic stagnation. When public debts become excessive or unpayable, pessimists advise explicit default or repudiation. They also tend to view financiers in general and public bondholders in particular as unproductive. Pessimists also usually endorse smaller-sized governments and free markets. With few exceptions, most public debt pessimists appear in the classical or public choice schools of thought; the most representative are David Hume, Adam Smith, and James Buchanan.

Public debt optimists believe that government provides not only productive services, such as infrastructure and social insurance, but also means of mitigating and correcting supposed “market failures,” such as savings gluts, economic depressions, inflation, and secular stagnation. Optimists contend that deficit spending and public debt accumulation can stimulate or sustain economy activity and ensure full employment, without burdening either present or future generations. To the extent that public debts become excessive, optimists tend to recommend default, whether explicitly or implicitly (by an inflationary debasement of the currency). Like pessimists, the optimists view financiers and bondholders as essentially unproductive, but unlike pessimists they defend a larger economic role for the state. Almost without exception, optimists reside in the Keynesian school of political-economic thought. Among the leading optimists, the most representative are Alvin Hansen and Abba Lerner.

Public debt realists contend that government can and should provide certain productive services, mainly national defense, police protection, courts of justice, and basic infrastructure, but that social and redistributive schemes tend to undermine national prosperity. Realists say public debt should fund only services and projects that help a free economy maximize its potential, and that analysis must be contextualized – that is, related to a nation’s credit capacity, productivity, and taxable capacity. According to realists, public leverage is neither inevitably harmful, as pessimists say, nor infinite, as optimists say. Realists view financiers as productive and insist that sovereigns redeem their public debts in full, on time, and in sound money. Realists favor constitutionally limited yet energetic governments that help promote robust markets. They appear mainly in the classical era of political-economic thought. The most representative and renowned of the public debt realists are Sir James Steuart and Alexander Hamilton.

Public debt pessimists and optimists differ from realists primarily in the way that they omit crucial context; whereas pessimists focus on the downside of public debt and de-emphasize its upside, optimists focus on the upside of it while de-emphasizing its downside. Realists, in contrast, tend to consult the wider, most relevant context.
A main thesis of this work is that the public debt realists provide the most persuasive theories and plausible interpretations of the long, fascinating history of public debt. Moreover, certain puzzles and paradoxes in contemporary public debt experience – including the recent, multi-decade trend of a simultaneous rise in public leverage ratios and decline in public debt yields, among developed nations – is explicable mainly in realist terms. In contrast, pessimists and optimists alike offer unbalanced, inadequate accounts of the public debt record: whereas pessimists are confused or mistaken in foreseeing an alleged “inevitable” ruin from public debt, optimists are confused and mistaken about the alleged economic “stimulus” attainable by large-scale deficit spending and debt build-ups. Looking to the future, the realist perspective will likely provide better interpretations of public debt policies and trends.

Credit is the most relevant context for debt. The limit of public debt (see Chapter 5) is circumscribed by public credit, or a sovereign’s capacity to borrow. The greater is public credit relative to public debt, the safer and cheaper is the borrowing, and the greater the possibility of further borrowing at affordable rates. A sovereign may have too much debt relative to its credit, but its credit alone can never be excessive. As Hamilton (1795) put it, public credit is the power “to borrow at pleasure considerable sums on moderate terms, the art of distributing over a succession of years the extraordinary efforts found indispensable in one, a means of accelerating the prompt employment of all the abilities of a nation.” As such, “there can be no time, no state of things, in which Credit is not essential to a Nation.” Moreover, national credit must rest “on grounds which cannot be disturbed” and fiscal affairs managed so as “to prevent that progressive accumulation of debt which must ultimately endanger all government.”

Prior to exploring the theory of public credit and debt in the works of the leading thinkers of the classical (Chapter 2), Keynesian (Chapter 3), and public choice (Chapter 4) schools, I present the three-century empirical record of public debt (Chapter 1). The schools aren’t homogeneous on public debt theory; pessimists, optimists, and realists can be found in each, although pessimists tend to congregate in the classical and public choice schools, while optimists reside in the Keynesian school and realists in the classical school. Having identified distinct strains of pessimism, optimism, and realism, and having learned that the realist approach is more persuasive and consistent with history, I apply this perspective to current debate on the limits of public debt (Chapter 5). Each approach has its proponents in the contemporary debate, but Chapter 5 conveys realism’s distinctive analytic advantage.

In examining the three schools of thought, I seek answers to questions on three levels: nature, causes, and consequences:
questions as to the nature of public credit and debt, including: the ways of characterizing public credit and public debt, and whether the two key concepts are distinguished; the view of private debt versus public debt, and whether or not they are analogous; external (foreign-held) debt versus internal (domestically held) debt, and whether the notion that “we owe it to ourselves” is valid; gross debt versus net debt, and whether a lower net debt entails less of a burden; national debt versus public debt (the sum of national plus state and local debt) and the implications of debt federalism; explicit debt versus implicit debt (or “off-balance-sheet” debt, reflecting longer-term obligations tied to public entitlements); whether it is sensible or possible to quantify limits to public debt, or its sustainability relative to national income, taxable capacity, or interest rates;

questions as to the causes of public credit and debt, including: the extent to which the roots of public debt are ethical-cultural, political-legal, and/or economic-demographic; whether some regime types (autocracy, democracy, intermediate types) are more or less prone to accumulate excessive public debts; why debts are incurred in wartime versus peacetime; whether deficit spending and public debts are temporary or permanent; whether public debt is incurred to fund transfers and outlays from an operating budget (consumption) or for capital and infrastructure projects (investment); why a state might treat minority groups (the rich) or posterity as “fiscal commons”;

questions as to the consequences (or incidence) of public credit and debt, including: effects on national income, the business cycle, savings, investment, inflation, interest rates and employment; whether deficit spending and public debt “stimulate” output or job creation, or instead “crowd out” private-sector activity; the effects of public debt on the size, scope, and spending capacity of government; its effects on the dependency of a government’s central bank; and whether, or to what extent the policies buttressing a burgeoning public debt entail “financial repression.”

Ideology and political regime types also influence public debt policies. Normatively, they reflect public preferences about the proper purpose, size, and scope of government, and how public goods should be funded. Positively, they reflect fiscal-monetary institutions, which in turn influence saving, investment, production, interest rates, and prices. Whether public debt is deemed harmful, beneficial, or innocuous, at root it’s a fiscal derivative of deeper factors; its value ultimately reflects citizens’ demands for public goods relative to their willingness and ability to pay for them through taxes, and investors’ willingness and capacity to buy and hold public bonds.
Although fiscal institutions, interacting with voter preferences, shape fiscal outcomes, the ethical-ideological norms that determine the size and scope of government, thus its resort to deficit spending, also tend to guide preferences for fiscal-monetary institutions. A democratic citizenry that demands (and is provided) more public goods than it is willing (or able) to pay for in taxes will likely oppose institutions designed specifically to constrain a government’s capacity to borrow or default on its debts. Such restraints as a balanced-budget amendment or mandatory monetary rules (in place of central bank discretion) will lack popular support. An electorate that truly opposes deficit spending and large public debts can simply vote against them, in which case no constitutional-institutional fiscal-monetary restraints would be necessary; in contrast, an electorate that condones deficit spending and large public debts will vote for them, in which case no constitutional-institutional restraints could be effective.

Despite distinct fiscal preferences, democratic political regimes unavoidably render fiscal rules either unnecessary or ineffective. Regardless, it’s not finance, economics, laws, or budgetary metrics that rule the fiscal world of unrestrained democracy, but instead the deeper, wider (more popular) preferences of the prevailing majority. Most political economists take public preferences as given, yet ideology ultimately determines preferences and political institutions, for good or ill (Hinich and Munger, 1994). For this reason, perhaps, public choice scholars, who are more interdisciplinary than rivals, have usually been more active in public debt debates.

Political ideology has strongly influenced public debt theory. The theories of the classical political economists embodied the classical-liberal (Lockean) conceptions of property rights and limited government that prevailed in the eighteenth (and much of the nineteenth) century. The Keynesian theory of public debt evolved in the wake of progressives hope for an ever-expanding state, which prevailed so tragically in the twentieth century. Public choice, while reviving some classical conceptions of public debt, also recognizes the crucial contemporary influences of unrestrained democracy.

In the two centuries prior to 1930 it wasn’t necessary to say much more about the cause of large public debts than “war.” One might ask why war, but it wasn’t necessary to ask “Why so much public debt amid war?” It was no mystery. Only in the last century, with the expansion of unrestrained democracy, welfare states, and social insurance schemes, have public debt theorists been obliged to incorporate in their work the powers inherent in both the warfare state and welfare state. Until 1930 the peacetime “norm” had been to restore pre-war budget balance and if possible generate budget surpluses to permit debt reduction; since 1930, with chronic deficit spending in wartime and peacetime alike, the norm has been perpetual public debt
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accumulation. The radical transformation of public finance over the past century deserves explanation beyond the merely economistic-positivistic; it both caused and reflected the vast increase in the size, scope, and power of the state and its root cause is arguably moral-ideological-political.8

No school – whether classical, Keynesian, or public choice – has eclipsed rivals, at least on public debt theory, which is now broadly eclectic or narrowly technical. Modern political theory and practice alike have given the world enlarged state spending relative to GDP, whether financed by taxes or (increasingly) by debt. Upon reflection I’ve come to sympathize with public choice theorists, not because they tend to be debt pessimists, but because they rightly attribute excessive public debt to unconstrained democracy, noting (uncontroversially) that political elites’ electoral incentive is to maximize spending, minimize taxation, and borrow or print money to plug the gap, while treating wealthy minority groups and future generations as fiscal commons worth exploiting.9

By now it should be obvious that governments borrow most when they are least willing or able to tax citizens presently and to the full extent needed to fund outlays. Beyond this, states unwilling or unable to constrain public spending, yet precluded from borrowing further, on affordable terms, tend to repudiate their debts, whether explicitly (by non-payment of principal and interest), or implicitly (by a deliberate inflation). When governments borrow to ensure their survival (in war), to effect a near-term economic recovery (from depression), or to foster longer-term prosperity (through infrastructure), their brief resort to deficit spending need not persist, nor must debt burdens mount. In contrast, chronic deficit spending may reflect a diminution in the assent of taxpayers to fully support rising public outlays, even as the resulting accumulation of debt diminishes public creditors’ expectations of repayment.

Public credit and debt also suffer from a problematic conflict of interest that makes it prone to being abused in unlimited democracies. In any society governed by a constitutionally limited state, the creditor-debtor nexus is free and legally secure; to the extent such a state borrows, it obeys the same norms and rules as market participants. Yet conflict arises when a less constrained government both adjudicates private creditor-debtor relations and itself becomes a dominant and burdensome debtor in markets. The unrestrained state is more likely to co-opt the banking system while enacting laws and conducting fiscal-monetary policies that favor its own interests at others’ expense.

Whether the causality runs from unconstrained majority rule to imprudent public finance, or the other way around, is less important than their coincidence and hostility to individual liberty, private property, and
economic prosperity. Direct democracy breeds public profligacy – and the reverse. They are mutually corroboratory.

At certain times in history, of course, realism demands a candidly negative assessment of political-economic trends, an interpretation that otherwise seems akin to latent pessimism. The evidence is ample that we’re living in such a time now, as states globally become more interventionist only a few decades after the dissolution of the Keynesian consensus and utter collapse of socialism in Eastern Europe. More than 70 years ago, E.C. Griffith (1945) foresaw the fundamentally anti-capitalist nature of interventionist states, with their chronic deficit spending and public debt build-ups:

The philosophy of deficit financing is but one part of a program that creates basic changes in the reactions of people that, per se, are sufficient to destroy the system of Capitalism, [which] rests upon the institution of private property, is motivated by the profit motive, and directed by a price mechanism functioning through the media of the market place... Planned economies – of which a cardinal feature is the policy of deficit financing – are directly opposed to the continuation of the milieu required for the preservation of the capitalist system... The presence of a national debt created and enlarged for the purpose of eradicating unemployment will produce an environment that is not conducive to the preservation of the capitalist system. If this proposition is true, then either the program of deficit financing or the capitalistic system must be abandoned. But when, in a democratic society, this condition becomes apparent, it will be impossible to abandon deficit financing and, hence, the alternative must be the abandonment of the capitalistic system.

To be clear, Griffith doesn’t contend that deficit spending by itself destroys capitalism. The claim would be absurd. He stresses how it’s one part of a broad anti-capitalist program: deficit-spending facilitates the evolution of a larger, more powerful, more invasive, and more redistributive state – all of which is inimical to private property rights.

A year after Griffith’s essay, Ruml (1946) applauds enlarged state power; he’s encouraged to see how more powerful central banks, an abandonment of the restrictive gold standard, and a greater reliance on public borrowing are all making tax revenues “obsolete.” He interprets the same facts differently, because he opposes capitalism while Griffith favors it. Ideology influences assessments of public finance. The anti-capitalist Keynes (1920) also favors fiat money, for as its real value “fluctuates wildly,” the “permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless,” and “wealth-getting degenerates into a gamble and a lottery.” Later, Keynes (1936) also demands “the euthanasia of the rentier” class (bondholders) by means of low or zero interest rates. Krugman (2014), Piketty (2014, 2015) and others today advise likewise.
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The public debt realists that I examine in this work tend to be more attentive to moral-political-legal issues than their pessimistic and optimistic counterparts. The realist is able to acknowledge genuinely bad times but also to find a way out. At the end of its Revolutionary War, America was effectively bankrupt. Incorporating a realist perspective in a 1781 letter to Robert Morris (then Superintendent of Finance for the Continental Congress), a young Alexander Hamilton advised against extreme assessments of public credit, and against the notion that public debt is either an unalloyed benefit or latent harm. “No wise statesman will reject the good from an apprehension of the ill,” he wrote:

The truth is, in human affairs, there is no good, pure and unmixed. Every advantage has two sides, and wisdom consists in availing ourselves of the good and guarding as much as possible against the bad. . . A national debt, if it is not excessive, will be to us a national blessing. It will be powerful cement of our union. It will also create a necessity for keeping up taxation to such a degree which, without being oppressive, will be a spur to industry.11

In place of pessimism or optimism, Hamilton offered a balanced, realistic perspective, which best explains the full history of public debt – to which we now turn.

NOTES


2. Calomiris and Haber (2014) attribute financial sector fragility to populist political pressures. In earlier studies Salsman (1990, 2013a, 2013b) attributed the fragility to modern central banks devoted more to enabling democratic overseers and underwriting profligate sovereigns than to ensuring sound money or safe banking.

3. Ciumas et al. (2012) find “strong empirical evidence for the hypothesis that imbalances built up in the private sector would eventually spill over to the public sector under the form of government deficit and increased public debt.” See also Breton et al. (2012, p. 57): “In financial crises, private debts typically turn into public debt” and “sovereign debt may balloon out of control because of actions taken to prevent the collapse of banking systems.” See also Per Tiwari et al. (2015, p. 2): “banking sector
expansions” “can create significant risks for the sovereign”; “When banking sector vulnerabilities unravel in banking crises, the risks to the sovereign are further exacerbated by the high fiscal cost of related crisis management policies, particularly bank bailouts [which are more likely] in countries with larger and more leveraged banking sectors.”

10. See Time (1965), Hicks (1975), Feldstein (1981), and Palmer (1990). More recently, see Giles et al. (2008), Meacham (2009), and Skidelsky (2009).
11. Hamilton (1781 [1961]).