The Political Economy of Public Credit

by

Richard Michael Salsman

Department of Political Science
Duke University

Date:_______________________

Approved:

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Michael C. Munger, Supervisor

___________________________
John H. Aldrich

___________________________
Thomas A. Spragens

___________________________
William R. Keech

Dissertation submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy in the Department of Political Science in the Graduate School of Duke University

2012
ABSTRACT

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Abstract

This dissertation critically examines predominant political-economic theories of public credit and public debt in light of the origins, development, and recent record expansion in such debt. Using a “history of thought” approach, I focus on those aspects of theory, from three main schools of thought – Classical, Keynesian, and Public Choice – which seek to explain the evolution of public debt, its political-economic causes and effects, the meaning of sustainability in public debt burdens, and the conditions under which governments are likely to monetize or repudiate their debts. For empirical context, I also provide three centuries of data on public debt for major nations, relative to their national income, and government bond-yield data for more recent decades.

There is value in classifying the major political economists who have examined public credit and public debt since 1700 as “pessimists,” “optimists” or “realists.”

Public debt pessimists argue that government provides no truly productive services, that its taxing and borrowing detract from the private economy, while unfairly burdening future generations, and that high and rising public leverage ratios are unsustainable and will likely cause national insolvency and long-term economic ruin. When public debts become excessive or un-payable, pessimists advise explicit default or deliberate repudiation. Public debt pessimists also believe financiers in general and public bondholders in particular are unproductive. Pessimists 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. Among prominent public debt pessimists, the most representative are David Hume and Adam Smith.

Public debt optimists believe that government provides not only productive services, such as infrastructure and social insurance, but means to mitigate what they perceived to be “market failures,” including 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 present or future generation. To the extent public debts become excessive or un-payable, optimists tend to advise implicit default, by official and deliberate debasement of the national currency (inflation). As do pessimists, public debt optimists view financiers and bondholders as essentially unproductive. Optimists also defend a relatively 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 –
i.e., 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.

My main thesis is that public debt realists provide the most persuasive theories of public credit and public debt, and thus the most plausible interpretations of the long, fascinating history of public debt. Moreover, certain puzzles and paradoxes arising in contemporary public debt experience, among developed nations – including the recent, multi-decade trend of simultaneously rising public-leverage ratios and declining public debt yields – is explicable primarily in realist terms. In contrast, public debt pessimists and optimists alike offer unbalanced, inadequate accounts of public debt experience. Whereas pessimists are too often confused or mistaken in foreseeing an alleged “inevitable” ruin from public debt, optimists more often than not are confused and mistaken about the alleged “stimulus” attainable by large-scale deficit-spending and debt build-ups. Looking ahead, the realist perspective is likely to provide superior guideposts for maximally-accurate interpretations of public debt policies and trends.
Dedication

To Lisa Lynn Principe, for showing me genuine love, and to the late John David Lewis, for showing me that ex-businessmen too can become serious scholars.
Contents

Abstract ......................................................................................................................................... iv

List of Tables ................................................................................................................................. x

List of Figures ............................................................................................................................... xi

Acknowledgements .................................................................................................................... xii

1. Introduction ............................................................................................................................... 1

2. Public Credit and Debt in History ....................................................................................... 12

3. Classical Theories of Public Credit .................................................................................. 37

   3.1 Public Credit and Britain’s Glorious Revolution.......................................................... 37

   3.2 Some Early Interpretations of Public Debt: Davenant, Melon, Berkeley, and Montesquieu ........................................................... 44

   3.3 The Debate Deepens: Hume, Steuart, and Smith ...................................................... 52

   3.4 The Early American Debate: Hamilton versus Jefferson.......................................... 94

   3.5 The Late-Classical Debate: From Say to Ricardo, Mill and McCulloch ................ 125

4. Keynesian Theories of Public Credit.................................................................................. 153

   4.1 Pre-Keynesian Context: Adams, Bastable, and Late-Classical Theory .......... 153

   4.2 World War I, the Resumption of Large Public Debts, and the Need for New Theory: A.C. Pigou ........................................................... 162

   4.3 The Depression-era Boom in Public Debt and Revival of Mercantilist Premises: J.M Keynes .......................................................................................................................... 174

   4.4 Secular Stagnation and the Possibility of Permanent Growth in Public Debt: Alvin Hanson .......................................................................................................................... 208

   4.5 “Functional Finance” as a Rules-Free Approach to Public Debt: Abba Lerner .. 230
List of Tables

Table 1: Gross Public Debt of 15 Advanced Nations as a % of GDP, 1870-2010 ............... 29

Table 2: Public Spending of 15 Advanced Nations as a % of GDP, 1870-2010. ................. 30

Table 3: The Paradox of Profligacy: Higher Public Debt Leverage Yet Lower Borrowing Rates, G-7 Nations, 1980-2010................................................................. 31

Table 4: The Empirics of Implicit Default on Public Debt: U.S Inflation and Leverage, Past & Future......................................................... 496
List of Figures

Figure 1: Public Debt of the U.K. as a % of GDP, 1700-2010 ................................................. 22
Figure 2: Public Interest Expense of the U.K. as a % of GDP, 1700-2010 ............................ 23
Figure 3: Public Spending of the U.K. as a % of GDP, 1700-2010 ........................................ 24
Figure 4: Public Debt of the U.S. as a % of GDP, 1800-2010 ................................................. 25
Figure 5: Public Interest Expense of the U.S. as a % of GDP, 1800-2010 ............................. 26
Figure 6: Public Spending of the U.S. as a % of GDP, 1800-2010 ......................................... 27
Figure 7: Public Debt of 22 Advanced Nations as a % of GDP, 1900-2010 ......................... 28
Figure 8: Projections of U.S. Federal Debt as a % of GDP, 2010-2035 ................................. 35
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1. Introduction

The past dozen years have seen an astonishing reversal of fortune in public debt. At the start of the 21st century most major nations, including the U.S., were enjoying consecutive years of budget surpluses, debating how long surpluses might last, and asking how far public debts might be cut without disrupting policy-making or markets.

Today, a dozen years on, quite opposite concerns prevail. The U.S. and major nations now run record budget deficits, and will likely do so for decades, 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 U.S. included, have lost their top debt ratings. The only seeming paradox is that as public leverage ratios have climbed, public bonds yields have plunged; yet the oddity is explicable by the return of an autocratic war-time policy known as “financial repression.” Still, low public debt yields suggest that sophisticated bondholders reject debt pessimists’ fears of a looming financial disaster and inevitable economic collapse. Meanwhile the debt optimists, who insist deficit-spending “stimulates” economies, cannot easily explain why those receiving the most stimulus (Japan, U.S.) still suffer persistent stagnation.

There seems no better time than now to reexamine public debt theory and practice. This dissertation critically examines predominant political-economic theories of
public credit and public debt in light of the origins, development, and recent record expansion in such debt. Using a “history of thought” approach, I focus on those aspects of theory, from three main schools of thought – Classical, Keynesian, and Public Choice – which seek to explain the evolution of public debt, its political-economic causes and effects, the meaning of sustainability in public debt burdens, and the conditions under which governments are likely to monetize or repudiate excessive debts. For empirical context, I also provide three centuries of data on public debt for major nations, relative to their national income, and government bond-yield data for more recent decades.

There is value in classifying the major political economists who have examined public credit and public debt since 1700 as “pessimists,” “optimists” or “realists.”

Public debt pessimists, we will see, argue that states provide no truly productive service, that their taxing and borrowing powers undermine the private sector while burdening future generations, and argue, further, that high and rising public leverage ratios are unsustainable and will likely cause public insolvency and economic ruin. Public debt pessimists recommend explicit default or repudiation when public debts become excessive, even though they also tend to endorse smaller-sized governments and free markets. With few exceptions, most public debt pessimists appear in the Classical school (Chapter 3) or the Public Choice school (Chapter 5) of political-economic
thought. Among the prominent public debt pessimists we will investigate, the most representative are David Hume and Adam Smith.

In contrast to the pessimists, public debt optimists believe that government provides not only productive services, such as indispensable infrastructure and security-enhancing social insurance, but various means to mitigate what they perceive to be “market failures,” including savings gluts, economic depressions, inflation, and secular stagnation. The optimists further contend that deficit-spending and public debt accumulation can stimulate or sustain economy activity and ensure full employment, without burdening present or future generation. To the extent public debts become excessive and un-payable, optimists usually advise implicit default, by an official and deliberate policy of monetary debasement (inflation), which can melt the real value of debt. Public debt optimists share with the pessimists the view that financiers in general and bondholders in particular are unproductive, so no great economic harm can be inflicted by public debt defaults, nor by any government playing a relatively-larger role in the economy, as most public debt optimists prefer. Most of the public debt optimists can be found in the Keynesian school of political-economic thought (Chapter 4), with their most representative members being Alvin Hansen and Abba Lerner.

The public debt realists, in contrast to the debt pessimists and optimists, contend that government can and should provide certain productive services, but primarily
national defense, police protection, courts of justice, and basic infrastructure; deficit-spending on social insurance or redistributive schemes the realists view as detrimental to maximum prosperity. Public debt, realists argue, should be reserved mainly for the funding of services and projects that help a free economy maximize its long-run growth potential. The realists insist that public debt analysis be contextualized – i.e., related to a nation’s credit capacity, productivity, and taxable capacity. Public leverage, they say, is neither inevitably disastrous (as pessimists fear) nor infinite (as optimists claim). Public debt realists also view financiers differently – that is, as productive – and thus insist that sovereign debtors redeem public debts honestly and fully, and eschew either explicit or implicit defaults. Realists favor sound money and constitutionally-limited but energetic governments that work to help promote robust markets. The realists appear mainly in the Classical era of political-economic thought (Chapter 3) and are best represented by Sir James Steuart and the first U.S. Treasury Secretary, Alexander Hamilton.

The main thesis of this dissertation is that public debt realists present the most persuasive theories of public credit and debt, and as such the most compelling and plausible interpretations of the long and fascinating history of public debt, including more recent and seemingly unprecedented experience. Unlike the realists, public debt pessimists and optimists alike have offered rather unbalanced and thus inadequate accounts of public debt experience. Whereas pessimists have exaggerated the potential
hazards of public debt, hazards which are certainly real to some degree, the optimists have exaggerated the potential benefits of public debt, which are equally real, in some important degree. Instead of one-sided hyperbole, a consistently realistic assessment of public credit and debt is needed, such that the carefully-considered benefits and hazards alike of public credit and debt are contextually revealed. Looking ahead, the realist perspective is more likely to provide superior guideposts for maximally-accurate interpretations of future public debt policies and trends.

In addition to exploring the theory of public credit in the works of the leading thinkers of the Classical (Chapter 3), Keynesian (Chapter 4), and Public Choice (Chapter 5) schools, we review the three-century empirical record of public debt (Chapter 2) as well as the limits of public credit and public debt (Chapter 6). The three schools, we will see, are not intellectually homogenous on public debt theory; to some extent pessimists, optimists, and realists can be found in each of the schools, although, as mentioned, the pessimists tend to congregate in the Classical and Public Choice schools, while optimists are found in the Keynesian school and realists gather in the Classical school. After surveying and assessing, in our intermediate chapters, the theories of public credit and debt advanced by Classical, Keynesian, and Public Choice scholars, in Chapter 6 we focus more narrowly on the “limits,” if any, of public credit and public debt. Having discovered distinct strains of pessimism, optimism and realism regarding public debt,
and having learned that the realist approach is more persuasive and consistent with the relevant history, in Chapter 6 we apply, to the current debate, this more illuminating perspective. Each approach – pessimistic, optimistic, and realistic – has its proponents in the contemporary debate, but Chapter 6 conveys realism’s distinct analytic advantage.

In examining the three schools of political-economic thought, we shall seek answers 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 public entitlements); whether it is sensible or possible to quantify limits to public debt, or its sustainability relative to national income, taxable capacity, or market 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, 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 war-time versus peace-time; 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 of public credit and debt, including: effects on national income, the business cycle, savings, investment, inflation, interest rates, employment, and unemployment; whether deficit-spending and public debt “stimulates” economies or job creation, or instead “crowds 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 polices buttressing a burgeoning public debt entail “financial repression.”

Thus the historic public debt debate can be classified along two distinct lines of tri-partite division – with pessimists, optimists, and realists addressing the nature, causes and consequences of public credit and debt. Yet there is also the crucial context of political regime-type, and questions as to the extent it exerts influence on public credit and debt. Deeper than merely a political phenomenon, public debt, by its nature, entails normative and positive dimensions. Normatively it reflects prevailing public preferences about the proper purposes, size and scope of government, and how public goods should be paid
for. Positively and directly, public debt reflects fiscal-monetary institutions, but it also influences saving, investment, production, interest rates, and prices. Yet whether its effects are deemed harmful, beneficial, or even innocuous, on normative grounds at least, public debt, as a fiscal derivative, ultimately reflects citizens’ demands for public goods relative to their willingness and ability to pay for them in taxes; of course, it also reflects investors’ willingness and capacity to purchase 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, tend also to guide preferences for fiscal-monetary institutions. A democratic citizenry that demands more public goods than it is willing (or able) to pay for in taxes also 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 vote accordingly for such outcomes, in which case no constitutional-institutional fiscal-monetary restraints would be necessary; in contrast, an electorate that condones deficit-spending and large public debts likewise will vote for them, in which case no constitutional-institutional restraints could be effective. Despite distinct fiscal preferences, the democratic political regime seems
unavoidably to render fiscal rules either wholly unnecessary or completely ineffective. Regardless, not finance, economics, objective laws, or budgetary metrics rule the fiscal world of unrestrained democracy, but rather the deeper, wider (more popular) preferences felt by the prevailing majority. In political economy preferences are taken as given; yet ideology may ultimately determine preferences and political institutions, for good or ill (Hinich and Munger 1994). If so, Public Choice scholars, who tend to be more inter-disciplinary than their rivals, may prove more influential in debates on public debt.

There is no question but that historically, ideology (political theory) has exerted a strong influence on public debt theory. The theories advanced by Classical political economists coincided with the classical-liberal (Lockean) conception of limited government that prevailed in the 18th (and much of the 19th) century. The Keynesian theory of public debt evolved in the wake of the progressive era’s quite different conception of the expansive state, which prevailed in the 20th century. Public Choice, while incorporating certain Classical conceptions of public debt, nevertheless endorses democracy, but contends for no definitive or limited government role. Neither Classical, Keynesian, nor Public Choice theories of public debt have wholly eclipsed those of rivals. Contemporary theories are now broadly eclectic or else narrowly technical. Nevertheless, path-dependency and inertia, in political theory and practice alike, have given the world an enlarged state share of GDP, whether measured by spending or debt.
Public Choice theorists generally attribute excessive levels of public debt to unconstrained democracy, noting un-controversially 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. Governments borrow when they are unwilling or unable to tax citizens presently and to the full extent needed to finance outlays. Beyond this, states unwilling or unable to constrain their 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 public debt burdens mount. In contrast, chronic deficit-spending may reflect a gradual diminution in the assent of taxpayers to support the rising cost of government, even as the resulting accumulation of public debt may lead to a diminution in creditors’ expectations of being repaid.

Moreover, public debt suffers from a problematic conflict of interest that makes it prone to abuse. In any civil society governed by a constitutionally-limited state, the creditor-debtor nexus is both free and legally secure; to the extent such a government borrows, it abides by the same norms and rules as market participants. Yet a material
conflict of interest can arise when a less-constrained government both adjudicates purely private creditor-debtor relations and itself becomes a dominant and burdensome debtor. 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.

The realists surveyed in the following chapters are more attentive to these moral-political-legal issues than are their rivals, the pessimists and optimists. Incorporating the realist perspective in a letter to Robert Morris, in 1780, a young Alexander Hamilton advises against extreme assessments of public credit, and against the notion that public debt is either an unalloyed benefit or a latent danger. “No wise statesman will reject the good from an apprehension of the ill,” Hamilton writes. “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.”

In place of pessimism or optimism, Hamilton offers a balanced, realistic perspective, which better explains the history of public debt – to which we now turn.
2. Public Credit and Debt in History

A concise yet broad-based history of public debt is a prerequisite to accurately understanding its causes and consequences. This chapter attempts such a history. Its value may be glimpsed when it is realized that no such history now exists, whether in book or article form. The historical context of public debt is important, as it can supplement and bolster alternative analytical approaches. Contemporary analyses of public debt, whether undertaken by economists or political scientists, are often overly formal, non-empirical, or focused narrowly on a sub-set of historical circumstances which may not be at all representative or illustrative of the basic and lasting principles of public debt. By one selective reading public debt may appear to be sinful, wasteful, and burdensome – by another, necessary and beneficial – and by another still, neither harmful nor beneficial but merely innocuous.

Governments in ancient and medieval times surely required funding, as do governments in every historical era, but rarely did they borrow “publically” in the sense of drawing funds from a wide population and making that same population effectively responsible for servicing the debt (paying principal and interest), as an equivalent of deferred taxes. Homer and Sylla 1991 explain how private borrowing existed from the beginning of recorded history and preceded the development of public borrowing by many centuries. Eventually public borrowing became more common, but initially it entailed borrowing in kind (commodities) rather than in money, for short rather than
long periods, and for war or idiosyncratic purposes rather than a permanent funding source. In ancient and medieval times no debt instruments existed in the form so familiar to us today, viz., tangible securities traded in secondary, liquid markets with prices and yields visible on public exchanges. This form of sovereign financial obligation emerged only in the late 17th century, when the rule of law, sanctity of contract, and parliamentary checks on arbitrary monarchical power took hold, mainly as a result of Britain’s Glorious Revolution (1688).

In the pre-commercial feudal era, princes, landlords and clerics owned estates or sanctuaries that generated income, not unlike a personal business, but these were command-and-control operations, in which tribute was paid by tenant farmers or serfs in return for military protection (Blanchard 2001, Bonney 1999, Botticini 2000, Cahill 2010, Munro 2002). Government funds in the feudal era also derived from the spoils of conquest and war, from the sale of offices, titles, and indulgences, or by debasing coins at the mint. Prior to the Renaissance, whenever monarchs, princes, and popes borrowed they did so on their own account, pledging personal income and estates as security. They often reneged on their debts. Creditors, initially lured by the prospect of large financial gains, given their privileged proximity to political power, more often than not were mistreated, whether by defaults, interest reductions, confiscations, or bodily harm (Homer and Sylla 1991, Shatzmiller 1990, Webber and Wildavsky 1986).
In an early account of sovereign debt in ancient times, Bullock (1930) describes how in the 4th century B.C Dionysus of Syracuse borrowed from citizens and then repaid the loan only by debasing the coinage. Today we may call this an implicit or indirect default, instead of an explicit or direct one; principal and interest are still paid, but not in the initially-promised medium of exchange. Governments resort to this method still today, as all now issue fiat paper money. In recent decades a few have issued inflation-indexed public bonds (the U.K. since 1982, the U.S. since 1997), mainly for information purposes or as policy guides; they are not a major part of total issuance. The old-fashioned term “debasement” has been out of favor for at least a century; today the method is called inflation (or “inflationary finance”) and the remaining analytical controversy is not whether the policy is proper or not but whether and to what extent creditors might act to offset its effects by requiring higher yields on public bonds.

Even though credit-debtor relations developed in ancient times, they stagnated and reversed in the dark ages and medieval period, due to a persistent animosity not only to money-making and commerce but also to usury. Originally usury meant lending money at an interest rate, not merely at a high rate (Brook 2007, Cahill 2010, Glaeser and Scheinkman 1998, Nelson 1949, Shatzmiller 1990). Aristotle had declared money “barren,” or unproductive, so charging interest was an exploitation or theft; but the ancients were not nearly as hostile to borrowing and lending as would be their religious
successors after the fall of the Roman Empire. For nearly a millennium the world’s major religions condemned, forbade, and punished money-making and lending at interest.

Eventually Aquinas provided a qualified defense of lending, which coincided with the origin and growth of modern, private banking and lending, starting in Italy and spreading quickly to Spain and Holland. With the Protestant Reformation came an unlikely defense of usury even by Martin Luther (1524). By the time of the 18th century Enlightenment, after commerce and lending at interest had flourished for two centuries or so, usury was given a robust and unqualified defense by Bentham (1787), which the classical economists – from Smith to Ricardo and Say and Mill – heartily endorsed. Obviously, without this more favorable attitude toward lending at interest, there would not have been so great a scope for an increase in debt of any kind, including public debt. The more favorable philosophical-cultural attitude toward economic activity and capital accumulation in general that was so characteristic of the Renaissance and Enlightenment also made available more lendable funds. Yet the latent and age-old (ancient-medieval) animosity toward bankers and lenders has never totally dissipated, and if anything was revived to a large degree in the mid-19th century with Marx’s critique of what he said was a parasitical, crisis-inducing late-phase of capitalism, called “finance capitalism.”

The persistent animosity faced by creditors has made it easier for over-extended borrowers, the largest among them being sovereigns, to renege on debts or demand debt forgiveness (Coleman 1999, Mann 2009, Skeel 2003, Suter 1992).
Prior to the 17th century Renaissance and 18th century Enlightenment in Europe, lending to governments meant lending personally to rulers, usually monarchs or popes (Cahill 2010). But these were largely the personal debts of the rulers, incurred mainly to wage war, to defend against invasion, or to fund infrastructure projects; as such they were not technically “public” debts, in the sense of being based on the paying capacity of the general public. These were state debts, repayable from the spoils of war or by the crown’s tax revenues or wealth transfers. Instead of relying on the precarious practice of borrowing funds under emergency settings, like war, monarchs, princes and popes instead preferred, if they could, to amass riches and armies in advance.

Indeed, mercantilism as a system not only of protectionism and regulation but also of public finance, precisely favored policies that built up, \textit{ex ante}, the cash holdings of the king and his nation-state, if need be at the expense of citizens or other nations. The aim of a “favorable balance of trade,” or net exports of goods in excess of their importation, was the net surplus importation of money (or specie) to pay for it. In this way a monarch would have a “war chest,” and need not borrow. In France mercantilism was personified in finance minister Colbert (1619-1683); the German counterpart to the policy of mercantilism was Cameralism, or the art and science of efficiently administering the royal finances.

As mentioned, the real origins and development of what we know today as the modern system of public debt coincides only with the rise of constitutionally limited and
representative government, especially in the wake of Britain’s Glorious Revolution in 1688. This was a revolt not of the masses, peasants, and serfs but of the wealthy – the taxpayers, lenders, and oligarchs. They were impatient and fed up with the crown’s land grabs, arbitrary exactions, cavalier defaults on loans, and opportunistic manipulations of the coin of the realm. Aristocratic and parliamentary restraints on the unilateral and arbitrary powers of the crown made possible a shift in the locus of public finance, from a focus on the personal finances of the king to the financial capacity of the general population. Thereafter public spending, taxing and borrowing would be undertaken in the name of the public, on its behalf, instead of being driven by royal edict or idiosyncrasy, it would be determined by regular, predictable, and commercial customs.

The financial revolution of the 17th and 18th centuries that preceded and made possible the more familiar industrial revolution of the 18th and 19th centuries entailed greater reliance on rule-based methods and procedures among creditors and debtors, a greater standardization of debt instruments and securities, and secondary markets where such securities could be traded, rendered more liquid and appropriate as collateral for additional borrowing (Dickson 1967). As debt securities became publicly traded and more visible, so also did their prices and yields; a public window thus opened upon the reputation and credibility (or lack thereof) of debtors, and sovereign debtors particularly began to recognize that if they were to exhibit an unquestioned creditworthiness they could borrow more easily and at lower rates relative to rivals, and

Evidence shows that amid the two-century, worldwide shift from monarchy to democracy, mainly during the 18th and 19th century, aristocratic-oligarchic governments were far more creditworthy and responsible about their debts and more just in their treatment of creditors compared to more democratic governments. The hypothesis has been that when the suffrage was limited and representatives were mainly landowners, merchants, and bankers, instead of lawyers or those drawn from the general citizenry, public credit was more restrained and responsible. The transition from an arbitrary rule by whim and by men to the rule of pre-established legal precedent fostered the further development of credit-debtor relations, including those between government (as debtor) and private creditors. Whereas most public debt scholars have argued that more representative forms of government permitted public debt issuance to
flourish, some have stressed a reverse causation – that the development of public debt made possible a vast expansion in democracy and freedom (MacDonald 2003). But the past century has seen not only a vast expansion in suffrage and democracy, but the spread of public fiscal imprudence. In the 18th and 19th centuries public debt issuance tended to expand sharply only during wartime, and then contract subsequently in peacetime, at least relative to national income; but in the more democratic past century deficit spending and high levels of public debt have become chronic, and despite some cyclicality, show a rising trend even in peacetime.

Of great importance to the subsequent development of public debt, during the Renaissance private banks evolved from providing a mere warehouse for clients’ specie deposits into fractional-reserve institutions that lent some fraction of deposits at interest, such that their assets became a mixture of precious metals and loans, or debt instruments (mainly commercial paper). This was the evolution known as “the organization of debt into currency” (Carrol 1964). Instead of currency being backed only by specie, it was backed by specie and assets that were the debts owed a bank by its borrowers. Initially currency was still redeemable at a fixed weight of specie, and was not yet monopolized by government or issued by states without backing. This device of backing currency with debt instead of specie eventually and gradually was adopted by central banks.
During the first two centuries of public debt issuance (the 18th and 19th centuries) coupon rates were fairly low, typically only 3-6% (Homer and Sylla 1991), mainly because most governments were fiscally prudent. They issued large sums of debt amid war, but otherwise did not run chronic budget deficits. In peacetime they also made pre-commitments – by sinking funds, annuities, and the gold standard – which assured creditors of timely repayment in money that would hold its value over time (Ross 1892, Sylla and Wilson 1999, Bordo and Rockoff 1996).

For much of U.S. history the federal government employed sinking funds to foster credibility in its commitment to pay principal at maturity. Annual budget appropriations would include a set-aside of sums to accumulate in an escrow-type fund to be used to repay the principal of public debt at maturity. The fund might also be used to support the market value of public debt; the treasury could selectively redeem those of its bonds that were trading below par; this practice boosted the bond’s price for existing holders (North and Weingast 1989, Sylla and Wilson 1999), making public debt less volatile and more attractive to hold. Public annuities were also used; instead of paying only interest during the life of the bond, and then the large principal payment all at once, at maturity, an annuity paid both interest and a steady portion of the principal semi-annually, such that a large lump sum of principal was not left payable at maturity. Like the sinking fund device, the annuity method was a more credible means of public
borrowing-repaying, and as such, permitted governments to borrow greater sums at lower interest rates.

The sinking fund method had been used in England and was inaugurated by U.S. Treasury secretary Alexander Hamilton in 1790 to enhance the public credit of the U.S. Sinking funds were a way of achieving credibility in government debt policy. Britain ceased resorting to sinking funds in the late 1800s, while the U.S. discontinued their use (along with the classical gold standard) in the 1930s. Unfortunately sinking funds were prone to political abuse and manipulation; as sums piling up in anticipation of repayment of principal due many years hence, they were an obvious temptation to those politicians who wished to spend the money sooner rather than later, and for more populist purposes than the repayment of principal to wealthy public bondholders. Many debt sinking funds were left underfunded, depleted, or discontinued, not unlike the U.S. Social Security trust fund (and those like it globally).

Visual depictions of the history of public debt in the West over the past three centuries can help us gain perspective on what precisely has occurred – and why. The longest-term data on public debt are available for the United Kingdom and the United States, but data for most other major countries are available since 1870.

For the United Kingdom since the Glorious Revolution in 1688, Figure 1 illustrates the long-term trend in the Debt/GDP ratio. Today’s ratio of 50% is well below the all-time high of 255% recorded at the end of the Napoleonic wars (1815), and also
well below the ratio seen after World War II (230%). Britain’s public debt ratio climbed steadily and precipitously amid repeated and costly wars between 1700 and 1815, but then declined just as precipitously during the relatively peaceful and prosperous century that lasted from 1815 to 1914. Today’s debt ratio, at 50%, is roughly where it was before the large run-up in public debt associated with World War I and World War II. Certainly the British government has engaged in chronic deficit spending in recent decades, but Figure 1 makes clear that it has not done so in excess of growth in national income.

![Figure 1: Public Debt of the U.K. as a % of GDP, 1700-2010](source: www.ukpublicspending.co.uk)

Figure 1 illustrates the interest expense that has been incurred by the British government on its public debt since 1700, also measured as a percentage of national
income. The pattern is similar to that seen in Figure 1: public interest expense has been high when the public debt ratio has been high, and low when the debt ratio has been low. Today Britain’s public interest expense is a mere 2.2% of its annual GDP, or less than a quarter of the 9.5% burden felt at the end of World War II and the still higher burden of 10% recorded at the end of the Napoleonic wars in 1815. Indeed, today’s ratio of 2.2% is lower than the ratio of 2.5% seen prior to the multi-year expansion of public debt that began a century ago on the eve of World War I.

![Figure 2: Public Interest Expense of the U.K. as a % of GDP, 1700-2010](source: www.ukpublicspending.co.uk)

Figure 2 plots the long-term ratio of annual government spending in the U.K, also as a percentage of annual national income (GDP). We see a saw-toothed but upward
climb in the relative size of the British government between 1700 to 1815, but then a long-term decline from roughly 33% of the economy in 1815 to less than 10% between 1850 and 1900. The spending share reaches the astounding heights of 57% amid World War I and 70% amid World War II, but today’s share, at 41%, is almost half the level of the previous record high, and despite increases in the role and scope of the British welfare state, the spending share has generally declined from 48% in 1981.

![Figure 3: Public Spending of the U.K. as a % of GDP, 1700-2010](source: ukpublicspending.co.uk)

Figure 3: Public Spending of the U.K. as a % of GDP, 1700-2010

Figure 4 shows the long-term trend in the Debt/GDP ratio of the United States soon after its founding in 1790. Today’s ratio is 100%, nearly triple the recent low of 35% in 1982, but also below the all-time high of 125% set in World War II. Wars have been the main cause of spiked in the U.S debt ratio – up to 18% at the end of the War of 1812, to
34% by the end of the Civil War, 37% at the end of World War I, and 125% after the end of World War II. The latest rise in the U.S. debt ratio might also be attributed to war, to the “war on terrorism,” but this has been a less expensive war than prior U.S. wars. The secular rise in the debt ratio since 1975 mostly reflects entitlement spending.

![Figure 4: Public Debt of the U.S. as a % of GDP, 1800-2010](source: www.usgovernmentspending.com)

The more recent, dramatic rise in the U.S. debt ratio is due as well to the large revenue loss and deficit-spending associated with the financial crisis and Great Recession (2008-2009) and thus more resembles the period of banking failures and Great Depression of the 1930s, when the U.S. debt ratio doubled from 18% to 36%. Thereafter, due to the deficit spending associated with World War II, it tripled from 36% to 125%.
Figure 5 plots annual U.S. public interest expense as a portion of GDP since 1800. Despite a high debt ratio lately (Figure 4), the interest-expense ratio remains relatively low, at 1.4%, because the average interest rate on U.S. public debt also has been relatively low compared to prior decades (the 1980 and 1990s). The record ratio occurred in the late 1980s, when the U.S. debt ratio was only 68%, but interest rates were much higher. From 1985 to 1990 the U.S. 10-year Treasury bond yield averaged 8.75%; but over the past five years, even under a much higher debt ratio, it has averaged a mere 3.25%.

Figure 5: Public Interest Expense of the U.S. as a % of GDP, 1800-2010
Figure 6 shows that federal spending in the U.S. is now 25% of GDP, compared to a 41% share in Britain, but the U.S. share is up sharply from 17% a decade ago. Nevertheless, the all-time high spending share was 48%, amid World War II.

Of course, the U.K. and U.S. have not been the only public borrowers in the world in the past few centuries, although they have been the largest ones in absolute terms. Figure 7 depicts the debt ratios of twenty-two advanced nations since 1900. As in the U.K. and U.S. graphs, we see spikes in debt ratios associated with World War I (1914-1918), the Great Depression (1930s), World War II (1940-1945), but also the recent rise in peacetime. The ratio at present is 88%, up from a low of 23% in the mid-1970s,
and from a more recent low of only 52% in 2007, just prior to the Great Recession of 2008-2009.

![Figure 7: Public Debt of 22 Advanced Nations as a % of GDP, 1900-2010](image)

Figure 7: Public Debt of 22 Advanced Nations as a % of GDP, 1900-2010

The data in Table 1 provide further and more specific context for the history of public debt, with an account of Debt/GDP ratio trends for 15 developed nations since 1870, including the U.K. and U.S. The highest public debt ratio in the table is that of Japan, nearly 200% in 2010, up from a 65% ratio when its stock market and economy peaked in 1990, and up also from a mere 12.1% ratio in 1970. The second largest ratio in 2010 is Italy’s, at 126.8%, up steadily from 104.5% in 1990 and 41.7% in 1970. Australia now has the lowest debt ratio – at 25.3%, compared to the 15-nation average of 83.2%.
That average is now double the average of 1970 (41.0%), yet not much above that seen in 1937 (76.1%).

### Table 1: Gross Public Debt of 15 Advanced Nations as a % of GDP, 1870-2010

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<thead>
<tr>
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<td>Switzerland</td>
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<td>−</td>
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<td>−</td>
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Seeking the potential origins of rising public debt ratios, in Table 2 we provide data on public spending by these same nations, also as a share of GDP, since 1870. For comparability, we include all spending in the U.S., at all three levels of government, which in 2010 was 42.3% of GDP (whereas the federal share alone was roughly 25%).

The world-wide trend is clearly upward. Whereas these 15 nations publicly spent an average of only 12.7% of national income a century ago, they spent 28.0% in 1960, 44.7% in 1990, and 47.0% in 2010. Today’s highest public spending ratio is France (56.2%), while the lowest is Switzerland (33.7%). Interestingly, since 1980 five nations have
actually reduced government spending as a share of GDP: Belgium, Germany, Netherlands, and Sweden. The biggest increases in relative spending since 1980 have occurred in the U.S. (+10.9% points, to 42.3%), the U.K. (+10.1% points, to 53.1%) and France (+10.1%, to 56.2%).

Table 2: Public Spending of 15 Advanced Nations as a % of GDP, 1870-2010

<table>
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</table>

Source for 2000 and 2010: OECD Fact Book 2011-2012 (December 2011)  
* U.S. data include all levels of government

Despite abundant evidence of a sharp increase in the public spending shares of national incomes by the most industrialized nations of the world in recent decades, and evidence also for an attendant expansion in both deficit spending and public debt ratios, Table 3 makes clear that greater public debt leverage has by no means translated into higher public borrowing costs. In the private sector, all else equal, greater leverage
usually entails a greater risk of debt default, which in turn induces creditors to demand compensation in the form of higher yields.

Table 3: The Paradox of Profligacy: Higher Public Debt Leverage Yet Lower Borrowing Rates, G-7 Nations, 1980-2010

<table>
<thead>
<tr>
<th>Nation</th>
<th>Public Debt as a % of GDP</th>
<th>Average 10-Year Government Bond Yields (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>51.2</td>
<td>65.1</td>
</tr>
<tr>
<td>Italy</td>
<td>58.1</td>
<td>104.5</td>
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<tr>
<td>France</td>
<td>30.9</td>
<td>40.2</td>
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<tr>
<td>U.S.</td>
<td>37.0</td>
<td>55.5</td>
</tr>
<tr>
<td>Germany</td>
<td>31.1</td>
<td>45.5</td>
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<tr>
<td>Canada</td>
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<td>U.K.</td>
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<td>39.3</td>
</tr>
<tr>
<td>AVERAGE</td>
<td>43.8</td>
<td>60.4</td>
</tr>
</tbody>
</table>

Source: OECD, IMF

Yet Table 3 makes clear that even though public debt ratios for the G-7 nations have increased steadily in recent decades – from an average of 43.8% in 1980 to 60.4% in 1990, 80.7% in 2000, and 109.7% in 2010 – their average benchmark (10-year) treasury yields have decreased – from an average of 11.9% in 1980 to 10.0% in 1990, 5.0% in 2000 and just 3.2% in 2010. We characterize this seemingly odd phenomenon as the “paradox of profligacy,” and seek to explain it, or at least untangle it to discern whether there is, in fact, no real paradox (see Chapter 6, Section 4). Perhaps what we observe in recent decades, in the realm of public debt, is not fiscal-financial “profligacy” per se, but rather market prices and yields on public debt conveying an accurate message, which, if true, rebuts a large body of pessimistic analysis of public debt.
No history of public debt would be complete without an account of the role of central banks, whose main task is not only to issue a government’s monopolized money supply but also to underwrite and distribute its public debt. To many economists and historians, the spread of central banking and fiat paper money systems over the past century must have been the counterpart to a supposed “market failure” in free banking and the gold standard, but the origins of central banks suggest otherwise. Most central banks originated in some government’s need to secure financing which it could not otherwise obtain by taxes or voluntarily loans; many began as private banks forced to provide public loans or those that became insolvent by holding defaulted public loans. Typically the offending government simply nationalized the insolvent bank and made it into a state or monopoly central bank, with control over a currency that eventually displaced gold as the reserves of private banks (Goodhart 1985).

This was the pattern by which most modern central banks were established, including the first two, in the late 17th century: the Swedish Riksbank, established in 1688 upon the takeover of a private bank initially founded in 1656 but which failed, and Britain’s Bank of England, established in 1694 as a means of financing yet another war with France. Britain’s modern public debt was effectively launched when William III arranged to sell public debt through a syndicate of London merchants; the syndicate eventually became the Bank of England. In similar ways, and for similar purposes, central banks were established in Denmark (1773), France (1800), Austria (1816), Norway
(1816), Belgium (1850), Netherlands (1864), Germany (1875), Japan (1882), Italy (1893), Switzerland (1905), the U.S. (1913) and Canada (1933).

Until the 1930s most of these central banks issued currency redeemable into a fixed weight of gold, just as most governments had pledged to redeem their debt in gold-convertible money. But since central banks were established mainly to assist governments in funding, they also purchased large sums of public debt – especially during war time – and used that asset as a basis for money creation. In this way the classical gold-coin standard was abandoned amid World War I, in favor of the more centralized gold bullion standard, and in turn that standard was abandoned in 1933 amid the Great Depression, in favor of the more paper-based gold-exchange standard (the Bretton Woods system), under which the U.S. dollar was the world-wide reserve currency and the only one redeemable into gold globally (and then only by other central banks). After the abandonment of the gold-exchange standard in 1971 no central bank in the world any longer had a currency linked to or redeemable in gold; all proceeded to issue fiat paper money. Initially, in the 1970s, this severing of currencies from any last tie to gold caused higher inflation expectations and thus rising public bond yields; but over the past four decades public bond yields, with some exceptions, have generally and steadily declined.

The current global monetary system, which is far less integrated than it was a century ago, entails no effective limit on central banks’ power and willingness to create
new money, and in turn this allows an even greater expansion of public debts than
history heretofore has seen. In the past decade the world’s major central banks have
purchased vast new sums of public debt by creating reserves or currency – a process
once described as “debt monetization” and “inflationary finance” is now referred to as
“quantitative easing” – yet the procedure has not caused higher debt yields. Perhaps this
is because leading central banks – especially in Japan and the U.S. – also have brought
short-term, inter-bank rates down to near zero percent, purportedly to facilitate
economic recovery, but more mainly to ensure low yields on public debt, to relieve the
pressure on already-strained budgets that arises from a fast-rising interest expense.

Much attention and analytical effort has been devoted in recent decades to the
drama associated with explicit defaults on public debts, but as scholars have shown,
such defaults are nothing new (Reinhart and Rogoff 2009, Suter 1992). More unexpected,
perhaps, is the fact that more highly-leveraged sovereigns nevertheless have been able
to borrow relatively easily and cheaply. Given that they do so, there is good reason to
expect still larger increases in public debt relative to national incomes over the coming
decades. In the next chapter we examine and assess the classical theory of public debate
for clues to this seeming puzzle.

In the U.S., the federal government has now recorded annual budget deficits
exceeding $1 trillion for four consecutive fiscal years (2009-2012, inclusive), such that an
average of 36% of spending has been financed by borrowing instead of tax revenues, or
quadruple the 9% share of spending borrowed in the post-World War II period through 2008. For comparison, 35% of spending was also borrowed during the decade of the Great Depression (1930-1939), and 51% of spending was borrowed during World War II. Looking ahead, independent budget analysts project that U.S. federal deficits will remain as wide over the coming decade, with the result that the U.S. national debt will continue to increase, not only in absolute terms but relative to GDP (Figure 8).


Given that fast-rising public debts are likely to remain a crucial issue and potential problem over the coming decades, not only for the U.S. government but for other welfare states globally that are pinched by fast-aging populations (hence faster-
rising outlays) and slow-growing economies (hence slower-growing tax revenues), theorists, empiricists and policymakers alike will have plenty to think about and plenty of work to do, in determining the true outer limits and capacities of public credit. We explore the limits of public credit in Chapter 6, but first, in the next three chapters, we examine Classical, Keynesian and Public Choice theories of public credit and debt.
3. Classical Theories of Public Credit

Classical theories of public credit in the 18th and 19th century were crafted during the Enlightenment, a period dominated by classical liberal ideas, a greater appreciation (relative to the medieval times) for the virtues and benefits of self-interested commercial activity, and constitutional commitment to a more limited, Lockean form of rights-based government. As we will see, this political-legal context proved crucial to the development of public credit and thus of credit theory. Britain’s political revolution in the late 17th helped establish the crucial foundation and context.

3.1 Public Credit and Britain’s Glorious Revolution

Britain’s Glorious Revolution of 1688 was foundational in establishing and encouraging modern creditor-debtor relations, as was usury, a practice much-less denounced as exploitive and increasingly defended as a capital deployed productively to borrowers who gained by it and should recompense lenders for it.

The rise of the commercial spirit was crucial to the growing diversification of economies away from a narrow reliance on agriculture. Private capital markets expanded enormously with the growth of foreign trade, manufacturing, and banking; in fact, the “financial revolution,” in which debt and equity became tradable liquid securities, was both cause and consequence of the new prosperity.

Without exception, but with interesting variations on the main theme, the leading classical economists – David Hume, Adam Smith, David Ricardo, Jean-Baptiste
Say and John Stuart Mill – held that government should live within its means, and its means should be limited. The classical political economists believed taxes should be light and government’s main tasks should include national military defense, local law and order, security of property and contract, and courts to handle commercial/bankruptcy proceedings; beyond that government might provide public schooling and limited infrastructure (roads, bridges, canals) – but little more.

For the classical economists government should operate as prudently as a household, balancing its budget and refusing to accumulate costly and burdensome debt; if debt was to be incurred it should be to defend the nation in war, or for productive purposes, not to finance consumption absent an income-generating repayment source. The classical theory denied that public deficit-spending added to the economy; public debt extracted private savings that by definition were rendered unavailable for private productive purposes. The classical economists warned against the harm of excessive public debt and the ruin such excess could bring to once-great nations; they also warned that over-indebted sovereigns were prone to mistreat creditors and default either explicitly or implicitly. In cases where public debts accumulated, classical economists recommended the use of prudent sinking funds.

In one of his thought experiments Ricardo posited that the real burden of government on the private economy was its spending, regardless of whether outlays were funded by taxes or borrowing; in either case, productive resources were extracted
from the private sector, unavoidably diminishing prosperity. Ricardo imagined further that markets would simply interpret new public debt as mere deferred taxation; they might save now to prepare for paying future higher taxes. The insight later became known as the “Ricardian equivalence” theorem, and was used to challenge Keynesian claims that deficit spending could make a net addition to national output. Yet others also doubted the notion that current but not future generations felt the extra debt burden.

For theorists of public debt, Britain and France tended to serve as distinct role models. Generally Britain was more fiscally prudent and stable than France, and some attributed this difference to the fact that Britain’s political governance was neither wholly monarchical nor wholly democratic, but instead largely aristocratic-oligarchic. France, in contrast, prior to 1789, was monarchical, and then briefly anarchical, then dictatorial (Napoleonic), then, from 1815 to the time of Bourbon restoration, a chaotic democracy. A third and perhaps superior role model was the United Provinces (Netherlands), which was so scrupulous financially as to be the global creditor nation.

The best, most prudent of the public debtors during the classical period made credible commitments, both fiscally and monetarily. Without resorting to balanced budget amendments in constitutions, nevertheless they abided by the balanced budget norm, at least during peacetime, and established sinking funds to prepare for retirements of principal; in the monetary realm prudent public debtors conformed to the classical gold standard (as did Britain, from 1717 to 1821), so creditors could feel
confident that they’d be repaid in sound money. Both Montesquieu (1689-1755), who heavily influenced America’s founders before they framed a new federal government in 1787-1788, and Alexis de Tocqueville (1805-1859), who observed the spread of democracy during America’s first few decades, opposed the excessive use of public debt, an interpretation they shared with David Hume, Adam Smith, David Ricardo and Jean-Baptiste Say. Indeed, in *Democracy in America* (1840) Tocqueville predicted that the more a nation became democratic, and less subject to a constitutional rule of law protecting property rights, the more likely its public finances would deteriorate. J.R. McCulloch (1789-1864), John Stuart Mill (1806-1873) and Karl Marx (1818-1883) also weighed in on public debt, but where the first two were conventionally classical, Marx argued that there should be not only a graduated income tax but a “centralization of credit in the hands of the state,” with no special devotion to meeting obligations to public creditors; indeed, such creditors were part of the exploitative class of capitalists that deserved no sympathy from a dictatorship of the proletariat. From this perspective was later fashioned the doctrine of “odious debt,” whereby a new state should summarily repudiate the debts of its political predecessor, especially if it was an enemy, whether due to a revolutionary overthrow of it from within or by an invasion of it from without.

Despite the usually-grim interpretations afforded public debt by influential writers in the classical period, public debt continued to expand and grow, largely without trouble; besides, a number of authors offered more sanguine views of public
debt, arguing that it was far preferable to oppressive taxation or monetary debasement, and ultimately could prove beneficial for both the state and the economy, so long as it was funded and managed prudently, with a fair provision for its extinguishment. Most notable in this group are Charles Davenant (1656-1714), Jean-François Melon (1675–1738), George Berkeley (1685-1753), Isaac de Pinto (1717-1787), Sir James Steuart (1713-1780), Alexander Hamilton (1759-1804), and Thomas Malthus (1766-1834). Most contemporary scholars interpret these more “optimistic” writers on public debt as mere precursors to the Keynesian view that would arise and begin to dominate in the early 20th century, but more accurately they lie somewhere between doomsday classical views and Pollyanna Keynesian views.

In the U.S., during the classical period, Hamiltonian financial principles and practices drew far more upon the more optimistic view of public debt, while Jeffersonian principles were more in line with the standard pessimism of the more widely-read classical thinkers. Alexander Hamilton (1755-1804) and Thomas Jefferson (1743-1826) differed sharply over such questions as whether government should borrow at all, whether it should pay its debts in full, even when public securities traded at a discount, whether the currency in which public debts were to be paid should be gold-backed and of uniform consistency nationally, whether public debts should extend from the current generation onto future ones or instead be cancelled every two decades or so, and even whether private banks were moral or legitimate.
As with modern public debt theorists, at least outside of those in the public choice school, most classical theorists of public debt devote more attention and analyses to the incidence and consequences of public debt than to its causes – and most view public debt as detrimental to a nation’s long-term prosperity and survival, even while acknowledging that most such debt is contracted in war, when a nation’s survival is more at stake than at any other time. Nevertheless, in the early 18th century there was not as yet a large welfare state; governments reluctant to finance war by taxes instead borrowed. War itself was considered an emergency, so public borrowing was seen as a temporary expediency, not a permanent or chronic policy tactic. Budget surpluses and debt reductions were to be pursued in peacetime. For classical economists no deeper theory of public debt causation seemed necessary; at most one might ask why some nations were more war-prone than others or why some waged war for longer periods of time than others. Some economists, like Ricardo, worried that the relatively greater ease associated with public borrowing, compared to the lesser pain associated with a less-than-fully-taxed citizenry allowed states to engage in war more often, at greater length, and more expensively than they otherwise might; yet such analysis treated public debt as a cause of increased spending and debt accumulation.

The classical period in political economy lasted for roughly a century after the publication of Adam Smith’s monumental *Inquiry Into the Nature and Causes of the Wealth of Nations* (1776), but the classical economists had precursors in the decades prior to
Smith's book, and after 1870 classical insights were re-cast in the form of neo-classical economics, with a major revision in value theory from one that had relied on cost of production and the quantity of labor inputs to one based on consumer choice and marginal utility. Classical public debt theory reflected classical value theory and arose amid the development and expansion of public borrowing by the U.K. government starting in the early 18th century and borrowing by the U.S. government later in the same century.

Classical economics technically extends up until 1870, at which point there developed the “marginal revolution” – Carl Menger, Stanley Jevons, and Leon Walras – with its emphasis on utility theory and its rejection of the labor theory of value that was so unique to the classical system (except in J.B. Say). The Neo-classical theory of public debt revived many of the key principles discovered by the classical school, albeit with marginalist variations; it thereby retrieved debt theory, somewhat, from the Marxian detour. But the political trend was against the Neo-classical theorists, given the rise of Bismarck’s welfare state in Germany, and the influence of populism-progressivism in America. By 1920 the U.S. had what it never had before: a high and graduated federal income tax (91%), a central bank (the Federal Reserve), a large public debt (35% of GDP, due to WWI, versus just 8% in 1900), and universal suffrage (now for women). Thus began a century that would entail a vast expansion in the size and scope of government, and in public debt, even in peacetime; this set the stage for Keynesian public debt theory.
and practice, which effectively jettisoned the main classical principles, in part by declaring national thrift to be a danger, and in part by insisting deficit-spending could stimulate prosperity.

In our assessments of classical-era writers we shall be concerned to discern their views on 1) the nature of public debt, 2) the history of public debt, 3) the moral-political-economic causes of public debt, 4) the consequences of public debt, and 5) the best treatment of public debts that have become unsustainable.

3.2 Some Early Interpretations of Public Debt: Davenant, Melon, Berkeley, and Montesquieu

The first major, modern work on public debt was written by Englishman Charles Davenant (1656-1714) just two decades after Britain’s Glorious Revolution (1688), when the government began borrowing as a sovereign on the credit of the public at large, as (partially) represented by King and Parliament jointly, and not alone upon the King’s personal assets and credit. In fact, Davenant had become the foremost authority on British public debt in the 1690s. A Tory, he had served as an MP even before the Revolution and had lost substantial capital in unpaid loans to Charles II. In 1695 Davenant issued his Ways and Means of Supplying the War, with the novel suggestion that the war (versus the Dutch) be funded almost exclusively by excise taxes instead of by borrowing. The sub-title of his more important work, for our purposes, his Essay Upon the National Credit of England (1710), conveyed his main goal: “To Render the Public Credit Highly Beneficial to the Government, Trade and People of This Kingdom.” No
critic of public credit, Davenant instead tried to develop means of placing it upon safer and sounder footings. According to Sir James Steuart, writing in 1767, “no person” besides Davenant “appears to have so thoroughly understood” the issues surrounding public debt at the time. The British government was then in constant conflict with creditors, unsure whether to appeal to their self-interest or punish them for charging too much. Davenant’s thesis is that public debts must be kept of short maturity, due in under a year, to ensure their liquidity and a ready public demand; he warned against long-term bonds as volatile, unreliable, illiquid and prone to political abuse (default).

In the quarter-century following Davenant’s first essay in 1695, Britain’s public debt nearly tripled, from £17 million to £47 million. As some writers began to worry about the burden of rising public debts, Jean-Francois Melon (1675-1738), a French mercantilist, declared, in A Political Essay Upon Commerce (1734), that the worries were largely unjustified, because “the debts of the state are debts owed by the right hand to the left, by which the body will be in no way weakened if it has the nourishment and is able to distribute it.” Thus Melon is one of the first modern writers to argue, in effect, that “we owe it to ourselves,” and that the more we owe, the more we also own. Yet Melon’s qualifiers were crucial: a state can safely issue considerable debt only if it “has the nourishment,” which means it has the tax revenues necessary to service its debt, and also if it “is able to distribute” its debt, which means that it can find willing purchasers.
Melon’s qualifiers imply that public debts can become excessive if tax revenues are deficient or if no public bond buyers can be found (or cannot be found without offering high interest rates). For Melon, “countries of great productions, and free from the dread of [the] revolutions which overturn states, will always be, whether in peace or in war, wealthy and powerful when the credits and the circulations are proportioned to their wants.” He rejects the claim made by some that “an unlimited quantity of debt is advantageous” to a nation, for such a view entails “running into extremes not to be supported.” Melon suggests a limit beyond which public debts are unsafe, but also says the limit is difficult to specify. He denies that some types of states are inherently more creditworthy. “Debts contracted by republics are no better secured than others,” he writes, although “it is to this credit that the republics owe their wealth and their power.” At root, Melon says, “the basis of credit is a security in the public contracts.” Melon should be classified not as an optimist on public credit and debt but as a realist.

Soon after Melon published his book, he found support for his optimistic views on public debt in Britain from an unlikely source, the rationalist philosopher George (Bishop) Berkeley (1685-1753), who touched upon public debt briefly but famously in The Querist (1735-1737). But unlike Melon, who is a realist, Berkeley is an optimist who sees no real downside to public debt. For Berkeley, “that which increases the stock [public debt] of a nation” is “a means of increasing its trade,” and “the credit of the public funds” constitutes not only “a mine of gold to England” but is also “the principal
advantage that England has over France,” and “over every other country in Europe.” As to the sometime “ruinous effects of absurd schemes and credit mismanaged,” that is not to be attributed to state-sponsored national banks, at least as long as they are devoted solely to promoting industry instead of mere speculation. Soon thereafter a Frenchman named Nicolas Dutot (1684-1741) tried to refute such sanguine views on public debt, in *Reflexions politiques sur les finances et le commerce* (1738). Dutot had worked in John Law’s French bank, before it collapsed amid the South Sea “bubble” of 1720-1723. Working in cahoots with an under-funded French monarch, and armed with special royal charters, Law tried to fuel a greater market demand for French public debt with a land-based, paper-money bank; after a brief and artificial boom, his bank (and French debt) went bust. Dutot became a critic of public debt, a position endorsed by Voltaire, and soon thereafter, also, from Charles-Louis de Secondat, baron de Montesquieu (1689-1755).

In *The Spirit of Laws* (1748) Montesquieu writes of how “some have imagined that it was for the advantage of the state to be indebted to itself: they thought that multiplied riches by increasing the circulation.” But, he adds, “those who are of this opinion have, I believe, confounded a circulating paper which represents money, or a circulating paper which is the sign of the profits that a company has, or will make by commerce, with a paper which represents a debt. The two first are extremely advantageous to the state: the last can never be so: and all that we can expect from it is, that individuals have a good security from the government for their money.” (Book XXII, Chapter XVII).
Montesquieu thus questions the then-predominant mercantilist wish to maximize domestic supplies of money (gold and silver). Most mercantilists believed that by issuing public bonds a sovereign could thereby induce households and businesses to hoard less gold and silver; as such, more money would circulate in exchange, be freed up to pay taxes, and serve as a readier and more liquid asset source for the state.

But Montesquieu counters such mercantilist claims, and relates how, in his view, public debt in fact entails a number of important “inconveniencies.” For one, he writes, “if foreigners possess much paper which represent a debt, they annually draw out of the nation a considerable sum for interest.” That would work against the mercantilists’ main aim of having money flowing into the nation instead of away from it. Second, “a nation that is thus perpetually in debt, ought to have the exchange very low.” Third, “the taxes raised for the payment of the interest of the debt are a hurt to the manufactures, by raising the price of the artificer’s labor.” Fourth, public debt “takes the true revenue of the state from those who have activity and industry, to convey it to the indolent; that is, it gives the benefits for laboring to those who do not labor, and clogs with difficulties the industrious artist.” After recounting these “inconveniencies” of public debt, Montesquieu adds, dismissively: “I know of no advantages.” As such, Montesquieu must be classified as a public debt pessimist.

For Montesquieu, to create public debt is not to create any net national wealth. A new debt creates an obligation (liability) in exchange for money (an asset) received from
a lender; this is no net addition to a nation’s net worth, and it may actually diminish it, since, as he argues, the debt raises business costs, rewards indolence relative to industriousness, and over time tends to sap a nation’s power to create wealth.

Montesquieu surmises that “people are thrown perhaps into this error” of believing public debt is net wealth because they believe “the paper which represents the debt of a nation is the sign of riches.” Yet they are deluded to believe such, that “none but a rich state can support such paper,” for if they see no fall in the value of public debt they think “it is a proof that the state has other riches besides.” People claim, illogically, that public debt “is not an evil because there are resources against it,” and also “an advantage, since these resources surpass the evil.” (Book XXII, Chapter XVII).

In Book XXII, Chapter XVIII of The Spirit of Laws Montesquieu addresses the issue of repaying public debts. He argues that “there should be a proportion between the state as creditor, and the state as debtor,” for “the state may be a creditor to infinity, but it can only be a debtor to a certain degree; and when it surpasses that degree, the title of creditor vanishes.” Montesquieu here hints at a question that many political economist have asked, before and since, but few have been able to answer, at least with any specificity: “What is a state’s maximum borrowing capacity?” It is certainly already known in the mid-18th century, when Montesquieu writes, that states have defaulted on debts; but it has not yet been clear what principles or metrics should guide either the public debt managers or the public debt creditors. Credibility is crucial, Montesquieu
argues: “If the credit of the state has never received the least blemish, it may do what has been so happily practiced in one of the kingdoms of Europe [England]; that is, it may acquire a great quantity of specie, and offer to reimburse every individual, at least if they will not reduce their interest.” But this is best achieved by the establishment of a sinking fund, which boosts investor confidence that the bonds will be serviced, which allows for the paying of a lower interest rate, and requires a state “to pay every year a part of the capital,” which is “a proceeding so happy, that its success increases every day.” British finance minister Sir Robert Walpole had set up the first sinking fund in England in 1717, although by 1731 it was being raided by Britain’s Parliament, with Walpole’s acquiescence, to help pay for non-debt public expenditures. Yet Montesquieu knew that England was an exception – a public debtor that mainly kept its promises – while others, notably his native France, were often irresponsible about credit. Yet even deadbeats may benefit by a sinking fund, for “when the credit of the state is not entire, there is a new reason for endeavoring to form a sinking fund, because this fund being once established, will soon procure the public confidence.” In such arguments Montesquieu seems to backtrack on his public debt pessimism, and to acknowledge at least some contexts in which such debt may be rendered safe and sustainable.

Montesquieu contends that republics are more likely to maintain their credit than monarchies, and that constitutionally-limited monarchies are more likely to do so than absolutist monarchies. Since the former abide by the rule of law, they tend to earn the
confidence of the law-abiding and the wealthy, those most likely to lend; the latter
governments tend to be arbitrary and viewed by public creditors as risky and
unpredictable. A republic, Montesquieu writes, “in its own nature” is a government
that is “consistent with its entering into projects of a long duration,” and thus need not
place as much capital in its sinking fund; a monarchy, in contrast, will be less trusted
and thus will have to set aside more in its sinking fund, or pay a higher interest rate.

As for securing tax revenues to service debt, Montesquieu advises resort to a
wide tax base; if only the rich are taxed, they are effectively made to pay for their own
interest income. “The regulations ought to be so ordered, that all the subjects of the state
may support the weight of the establishment of these funds,” he writes, “because they
have all the weight of the establishment of the debt.” Montesquieu locates four social
classes who pay public debts: proprietors of the land, trade merchants, laborers and
artificers, and annuitants. He believes the last class, typically also the richest, ought to be
taxed relatively more than other classes – they “ought least to be spared” taxes –
because, he says, “it is a class entirely passive, while the state is supported by the active
vigor of the other three.”

In this last argument Montesquieu holds an anti-creditor premise that runs
throughout the classical era, and even thereafter, to our present age: that financiers and
creditors (whether of the state or others too) are essentially unproductive and parasitical.
Yet Montesquieu advises against over-taxing the financiers of state, for they “cannot be
higher taxed without destroying the public confidence, of which the state in general, and these three classes in particular, have the utmost need.” There is a paradox in the claim: the financier is deemed unproductive and superfluous, yet also a crucial driver of a nation’s prosperity and an indispensable source of the state’s fiscal sustenance. A state may be tempted to breach credit agreements with its financiers, and morally it may be within its “rights” to do so, but that can be seen by others, who may react badly. “As a breach in the public faith cannot be made on a certain number of subjects without seeming to be made on all,” Montesquieu warns, and “as the class of creditors is always the most exposed to the projects of ministers,” “the state is obliged to give them a singular protection, that the part which is indebted may never have the least advantage over that which is the creditor.”

3.3 The Debate Deepens: Hume, Steuart, and Smith

According to David Hume (1711-1776), in his essay “Of Public Credit” (1752), government borrowing invariably brings with it “poverty,” national “impotence,” and ultimately, a nation’s political “subjection to foreign powers.” Public borrowing is, he warns, “a practice which appears ruinous, beyond all controversy.” Hume predicts that Britain will become insolvent in under a half-century, that is, by 1800. “Either the nation must destroy public credit, or public credit will destroy the nation,” he concludes, hinting that he would prefer the destruction of public credit, as the number of creditors is smaller than the larger citizenry who are unfairly burdened and harmed by the taxes
necessary to service the large public debts bequeathed by ancestors. Yet Hume does not explain why public debt defaults or repudiations will not also inflict harm on a nation.

In the half-century before Hume wrote “Of Public Credit,” Britain’s public debt had increased dramatically from just £14 million (1700) to £77 million (1750). By the time Hume died a quarter-century latter (in 1776) Britain’s public debt had risen to £127 million, and although he did not live to see the sum climb still further, to £427 million by 1800, he would have said his projection was vindicated. Yet Britain’s public debt peaked at £819 million in 1819, after the Napoleonic wars, and thereafter declined steadily to just £569 million by 1900. Far from being “ruined,” Britain enjoyed the heyday of its empire during the 19th century, as peace reigned and the economy expanded. National income data were not available to classical economists, and besides, they tended not to bring statistical context to their discussions of public debt; they cited debt levels but rarely if ever related them to a nation’s capacity to generate the income and tax revenues needed for debt service. In retrospect, however, armed with national income estimates from the period, we know that the ratio of Britain’s public debt to its GDP increased markedly from just 22% in 1700 to 105% in 1750 and a peak of 255% in 1819; thereafter the ratio declined steadily to 100% by 1876 and a low of 25% on the eve of World War I (see Figure 1, Chapter 2). Thus while Hume correctly foresaw the rise in Britain’s public debt, he over-estimated its true magnitude, and certainly would not have predicted the material and steady decline in the Debt/GDP ratio witnessed in the decades after 1819.
The state of Britain’s public debt had bothered Hume at an even earlier date than 1752, notably in his essay “Of Civil Liberty” (1741), where he suggests that no honorable nation should become beholden to “financiers,” whom he derided as “a race of men rather odious to the nobility and the whole kingdom.” Popular governments, Hume argues, are more prone than other types to depend slavishly on money-lenders. Although he concurs that “monarchical governments have approached nearer to popular ones, in gentleness and stability,” nevertheless “they are still inferior” to republics, except in one crucial respect: public debt. “In monarchical governments there is a source of improvement, and in popular governments a source of degeneracy,” and “the source of degeneracy, which may be remarked in free governments, consists in the practice of contracting debt, and mortgaging the public revenues, by which taxes may, in time, become altogether intolerable, and all the property of the state be brought into the hands of the public.” Noting that public debt is a modern phenomenon, and co-extant with the spread of popular government, Hume recounts how, “among the moderns, the Dutch first introduced the practice of borrowing great sums at low interest, and have well nigh ruined themselves by it.” He concedes that absolute monarchs (as in France) also have mishandled debt, but “as an absolute prince may make a bankruptcy when he pleases, his people can never be oppressed by his debts,” but “in popular governments, the people, and chiefly those who have the highest offices, being commonly the public creditors, it is difficult for the state to make use of this
remedy, which, however it may sometimes be necessary, is always cruel and barbarous.
This, therefore seems to be an inconvenience, which nearly threatens all free
governments; especially our own, at the present juncture of affairs.” For Hume a public
debt repudiation is a viable “remedy,” even though a “cruel and barbarous” one, but it
is far easier to enact in an absolutist state than in a popular one, because in the latter the
debt is more widely-held.

It is worth understanding Hume’s argument that public debts of any size are no
trouble to an absolutist state, but invariably precarious in a popular state or republic. “If
the prince has become absolute,” he says, “it is so easy for him to increase his exactions
upon the annuitants, which amount only to the retaining money in his own hands,” for
“the whole income of every individual in the state must lie entirely at the mercy of the
sovereign.” On the contrary, in a popular state relying on the consent of the governed
and acquiescence of the taxpayer, when “the consent of the annuitants be requisite for
every taxation, they will never be persuaded to contribute sufficiently even to the
support of government,” because “the diminution of their revenue must in that case be
very sensible,” and “would not be shared by any other order of the state, who are
already supposed to be taxed to the utmost.” Hume says that most republics have low
tax burdens, but this means they cannot easily service public debts,” and “where a
government has mortgaged all its revenues,” it “necessarily sinks into a state of languor,
inactivity, and impotence.” Although popular states are seen as having more secure electoral foundations, they may become more fiscally precarious than autocratic states.

In “Of Public Credit” (1752), Hume recounts how in ancient times states tended not to borrow but rather to accumulate treasure in advance of emergencies like war, and how public borrowing is a more recent and “modern” phenomenon, beginning in the 17th century; by his own reckoning, considering the burdens he says that public debts place upon future generations (“posterity”), “the ancient maxims are, in this respect, more prudent than the modern” maxims. Hume does not explain why no equivalent burden is placed on current generations by the vast taxes necessary, in lieu of issuing public debt, to accumulate treasure-in-advance. He assails “our modern expedient, which has become very general . . . to mortgage the public revenues, and to trust that posterity will pay off the encumbrances contracted by their ancestors.” This he calls “a practice which appears ruinous, beyond all controversy.” For Hume the fiscal maxims of state should mirror those of households, “for why should the case be so different between the public and an individual, as to make us establish different maxims of conduct for each? If the funds of the former be greater, its expenses are also proportionately larger,” and “if its resources be more numerous, they are not infinite.” While it is true, he adds, that “abuses of [accumulated] treasures be dangerous, either by engaging the state in rash enterprises, or making it neglect military discipline, in confidence of its riches, the abuses of mortgaging are more certain and inevitable:
poverty, impotence, and subjection to foreign powers.” Clearly, Hume prefers that modern public funding rely on *ex ante* treasure, not *ex post* borrowing.

Reiterating the theme of his 1741 essay, that popular governments are more likely than absolutist ones to resort to public borrowing, to “mortgaging posterity,” in his 1752 essay Hume posits a motive: “It is very tempting to a [finance] minister to employ such an expedient, as enables him to make a great figure during his administration, without over-burdening the people with taxes, or exciting any immediate clamors against himself. The practice, therefore, of contracting debt will almost infallibly be abused, in every government. It would scarcely be more imprudent to give a prodigal son a credit in every banker’s shop in London, than to empower a statesman to draw bills, in this manner, upon posterity.” Hume says “every government” is tempted to spend on current citizens with funds that ultimately are repaid by future, as-yet-unborn citizens, but clearly this temptation is greater in popular than in autocratic governments. In this case Hume adopts what is now known as a public choice perspective – which we survey in Chapter 5.

Although Hume is not insensitive to the benefits of public debt, he believes they are outweighed by its many hazards and its “degeneracy.” In “Of Public Credit” (1752) he explains certain benefits, such as public securities being safe and liquid, and serving like money, and providing a convenient way to hold capital while earning interest; they can be pledged easily to bankers as collateral for private loans. And since “our national
debts furnish merchants with a species of money that is continually multiplying in their hands, and produces sure gain, besides the profits of their commerce,” they “enable them to trade upon less profit,” which “renders the commodity cheaper,” “causes a greater consumption,” “quickens the labor of the common people,” and “helps to spread arts and industry throughout the whole society.” Hume sees that “more men, therefore, with large stocks and incomes, may naturally be supposed to continue in trade, where there are public debts,” and “this is of some advantage to commerce,” by “promoting circulation” and “encouraging industry.” Of course, this activity will also increase national income, and thus render debt burdens less than they otherwise might be; but Hume does not make this connection. He does not relate public debt levels to national income, not even conceptually, even though he believes higher levels of public debt contribute importantly to growth in national income. Despite these acknowledgements, it is difficult to interpret Hume as anything other than a pessimist on public debt.

Hume also exhibits hostility toward financiers so intense that it seems to prejudice him against public debt per se; instead of despising bond-holders because of the type of bonds they hold, he seems to despise public bonds based on his loathing of their holders. For Hume, financiers “are men who have no connections with the state,” unlike landlords, because financiers are left free to “enjoy their revenue in any part of the globe in which they choose to reside,” and tend to “live anonymously,” and to “naturally bury themselves in the capital or in great cities,” where they “sink into the
lethargy of a stupid and pampered luxury, without spirit, ambition, or enjoyment.”

Hume openly disdains the commercial-financial life-style and believes it sins against “all ideas of nobility, gentry, and family.” He worries that liquid stock and bond portfolios “can be transferred in an instant, and being in such a fluctuating state, will seldom be transmitted during three generations from father to son,” and that this form of wealth will “convey no hereditary authority or credit to the possessor.” A such, society’s fixed hierarchy will erode, until “the several ranks of men, which form a kind of independent magistracy in a state” “are entirely lost.” With the removal of “the middle power between king and people” (landholders), he predicts, “a grievous despotism must infallibly prevail.” Landholders left destitute will be “unable to make any opposition” to the growing power and parasitism of the financiers. Honest and popular government will be sacrificed to the commercial–financial class, with elections “swayed by bribery and corruption alone.” Absent a conservative societal hierarchy, “no expedient remains for preventing or suppressing insurrections” and “no expedient at all remains for resisting tyranny.” Hume worries that liberty may ultimately yield to tyranny, but does not prove why financiers must necessarily bring tyranny.

For Hume the hazards of public debt are greater than the benefits, yet beyond vague and splenetic declamations about financier-fostered tyranny, none of the five hazards he names seem to diminish national income or undermine its growth. First, he says, “national debts cause a mighty confluence of people and riches to the capital, by
the great sums, levied in the provinces to pay the interest.” He thinks it against the “public interest” that “so many privileges should be conferred on London, which has already arrived at such an enormous size, and seems still increasing.” In Hume’s metaphor, “the head is undoubtedly too large for the body,” yet he also praises London as a “great city” which is “happily situated,” and says “its excessive bulk causes less inconvenience” than smaller capitols elsewhere. To be sure, this is an odd claim. Hume’s foremost complaint against Britain’s public debt is that it coincides with or encourages a concentration of citizens and wealth in a major, vibrant city, the nation’s capitol; he thinks it’s a problem that London is becoming the financial capitol of the world. Second, Hume says that although the public debt may serve as near-money, as one of its advantages, it does this job so well that it tends to “banish gold and silver from the most considerable commerce of the state,” to “reduce them to common circulation,” and even to raise the cost of living. Third, he warns that public debts create a tax burden, that taxes are “levied to pay the interest of these debts,” and, he contends, this not only raises the cost of labor to employers, but specifically oppresses “the poorer sort.” Fourth, a growing public debt means that “foreigners possess a great share of our national funds,” and in time this may involve a “transport of our people and our industry,” that is, an out-migration from Britain. Fifth, and finally, Hume insists that public securities are usually held “in the hands of idle people, who live on their revenue,” and if public debts expand, so also will idleness; the public debt will give “great encouragement to a useless
and inactive life.” This objection not only conforms to Hume’s latent disdain for the lifestyles and morals of financiers, but also explains his unwillingness to conclude that the greater commercial activity fostered by public debt will be sufficient to help service the debt; in his fifth objection he argues that the same accumulation of public debt will breed not prosperity but sloth. Hume contends that public debt will generate more idleness than industriousness.

Hume’s third objection to public debt, which pertains to the tax burden it might eventually require, and the deleterious effects that burden might exert on the economy, is perhaps the only one of his objections that relate to the nation’s prosperity, and thus to its capacity to service and discharge public debt. Thus his treatment of the tax-based limits to the public debt burden is worth recounting. For Hume, “it will scarcely be asserted that no bounds ought ever to be set to national debts,” and it is false to believe that no tax burden could be too high, in effect that “the public would be no weaker, were twelve or fifteen shillings in the pound, land-tax, mortgaged, with all the present customs and excises.” In Hume’s time, before decimalization, the British pound consisted of twenty shillings, so the phrase “twelve or fifteen shillings in the pound” meant a ratio of 12 to 20 and 15 to 20, respectively, or tax rates of 60% and 75%. Although there is no evidence that these were the actual British tax rates at the time, Hume uses them to illustrate his dire claim that public debt will be ruinous. He asks readers to “suppose the public once fairly brought to that condition, to which it is
hastening with such amazing rapidity,” wherein land is taxed “eighteen or nineteen shillings in the pound” (or 90-95%), “for it can never bear the whole twenty” (a tax rate of 100%), and further “suppose all the excises and customs to be screwed up to the utmost which the nation can bear, without entirely losing its commerce and industry,” and then also “suppose that all those funds are mortgaged to perpetuity,” and lastly, the point is reached when no new tax can serve “as the foundation of a new loan.”

Given such a punitive tax policy, Hume concludes, “the seeds of ruin are here scattered.” He blames public debt itself, not the spending which it funds. In truth, British tax rates at the time, whether on land, luxuries (“excises”), or imports (“customs”) were not close to 60%, let alone to 95%, and only a few decades later (1798), Britain enacted an income tax (albeit abolished in 1816), so other revenues sources were found, defying Hume’s skepticism. Between 1750 and 1800 Britain’s public debt jumped more than five-fold, from £78 million to £427 million, but its total tax revenues increased even more so, nearly seven-fold, from £7.4 million to £50.3 million, and the share of total state spending devoted to public debt service in 1800 was identical to that in 1750: 33% (Churchman 2001: 129-131). Hume assumed that rising public debts must raise tax rates, and to confiscatory levels that would destroy incentives to produce, save and invest, thus killing the economy’s capacity to generate revenues and service debt; he was right to surmise that high tax rates might do harm, but wrong to claim Britain’s existing (or projected) levels of debt would crush the economy or, absent that, require high tax rates.
Given the analytical ambiguities and statistical deficiencies in his discussion of public debt burdens, Hume is reluctant to specifically project a national insolvency, although he seems certain it will come, eventually, because, he says, “Britain is visibly tending” toward the five “disadvantages” of public debt he lists, and this is “not to mention the numberless inconveniencies, which cannot be foreseen, and which must result from so monstrous a situation as that of making the public the chief or sole proprietor of land.” Hume insists that British insolvency is a “not very remote” event, and “one would incline to assign to this event a very near period, such as half a century” – that is, circa 1800. Writing in 1752, Hume notes that others before him have made faulty forecasts of a pending national bankruptcy; he would be more specific in his prediction, he says, “had not our fathers’ prophecies of this kind been already found fallacious, by the duration of our public credit so much beyond all reasonable expectation.” Consequently he will be “more cautious than to assign any precise date” to a future British bankruptcy, and will limit himself to simply “pointing out the event in general” – in short, that it will happen someday, somehow, in some way.

Hume doubts that spending restraint can cure what will ail Britain’s finances, that “any future ministry will be possessed of such rigid and steady frugality, as to make a considerable progress in the payment of our debts.” Yet “it may not be difficult to guess at the consequences” of Britain’s public debt, for “it must, indeed, be one of these two events; either the nation must destroy public credit, or public credit will destroy the
nation.” For Hume “it is impossible that they can both subsist, after the manner they have been hitherto managed, in this, as well as in some other countries.” Hume effectively assumes an inherent, irreconcilable conflict between sovereign debt and political sovereignty; these cannot coincide harmoniously; one must destroy the other, eventually. Since Hume assumes this to be inevitable, and since he also prefers that Britain survive as a nation, he prefers that her credit be destroyed. This can happen in two ways, he says, one which preserves Britain’s sovereignty, the other which ends it.

The first Hume classifies as the “natural death” of public debt, a deliberately-chosen default or repudiation of it by the British government; the second he classifies as the “violent death” of public debt, when the nation, rendered weak by its own debt burdens, is conquered by a foreign rival, which summarily dismisses its victim’s debts as not its own.

Hume makes light of the consequences of “natural death” for public debt, which more accurately is the murder of public debt, since it is a deliberate government policy, one Hume calls “voluntary.” After the inevitable erosion of public credit, “the whole fabric, already tottering, falls to the ground, and buries thousands in its ruins.” Yet the buried rise to lend yet again, for “so great dupes are the generality of mankind, that, notwithstanding such a violent shock to public credit, as a voluntary bankruptcy in England would occasion, it would not probably be long before credit would again revive in as flourishing a condition as before.” The best time and safest way to lend to any state
is after it has relieved itself of great debt burdens, not before; despite its diminished credibility, the defaulting state will soon thereafter find creditors who quickly and greedily return as eager lenders-to-state. Hume insists that the creditors in such cases act not recklessly but prudently, for “a prudent man, in reality, would rather lend to the public immediately after we had taken a sponge to our debts, than at present,” just as much as “an opulent knave, even though one could not force him to pay, is a preferable debtor to an honest bankrupt.” The knave, to carry on his business, “may find it his interest to discharge his debts,” whereas the honest bankrupt has the willingness but not ability to repay. Hume believes “men are commonly more governed by what they have seen, than by what they foresee, with whatever certainty,” and “promises, protestations, fair appearances, with the allurements of present interest, have such powerful influence as few are able to resist.” Thus public creditors are tempted, just as “mankind are, in all ages, caught by the same baits, the same tricks, played over and over again.”

With public over-indebtedness, Hume asks “What then is to become of us?” Will it be a natural death for public credit, or a violent one? Will Britain survive or not? She must not await events, he says, and hints at something like a Biblical jubilee, wherein debts are viewed as a “slavish” oppression, and mercy demands they be dismissed or forgiven. “Were we ever so good Christians, and ever so resigned to Providence,” Hume writes, “this, methinks, were a curious question, even considered as a speculative one,” and “it might not be altogether impossible” to effect such a remedy. This would be part
of what he calls a “natural death” for onerous public debt, but with religious overtones of personal sacrifices to made by the few, for the sake of the many, that is, by creditors on behalf of citizens, for the good of society and survival of the nation. Hume estimates that in contrast to the millions of citizens who will be perpetually burdened by taxes, to service public debts, “all the creditors of the public” amount to only 17,000 people, and although a default on public debts would soon likely render them “the lowest, as well as the most wretched of the people,” the result would be worth it, to preserve the nation.

Laursen and Coolidge (1994) document how, despite active engagement with critics of his view, Hume, until the day he died, did not abandon his view that public debt entailed “degeneracy” or that Britain would go bankrupt. Hont (1993) is less critical of Hume’s views on debt, tracing them not to his distaste for financiers but for wars.

Around the time of Hume’s essay on public debt, famed British jurist, Sir William Blackstone (1723-1780), also weighed in on the topic, when writing on the King’s revenues in his *Commentaries on the Laws of England* (1753). Blackstone had a great influence on those American founders trained in law. In Book I, Chapter VIII (“Of the King’s Revenue”) he attributes Britain’s national debt to a large increase in spending on administration and war after the Revolution of 1688, and a reluctance to fully tax citizens. For political leaders “it was not thought advisable to raise all the expenses of any one year by taxes to be levied within that year, lest the unaccustomed weight of them should create murmurs among the people.” Instead “the policy of the times [was]
to anticipate the revenues of their posterity, by borrowing immense sums for the current
service of the state, and to lay no more taxes upon the subject than would suffice to pay
the annual interest of the sums so borrowed: by this means converting the principal debt
into a new species of property, transferable from one man to another at any time and in
any quantity." Initially it seems Blackstone will detect a net benefit, for "by this means
the quantity of property in the kingdom is greatly increased in idea, compared with
former times," yet it is mere idea, because "if we coolly consider it," he adds, real
property is "not at all increased in reality," and although "we may boast of large
fortunes, and quantities of money in the funds," "where does this money exist?" It exists
only in name, he says, as paper, "in public faith, in parliamentary security," and
although that may satisfy creditors, what’s been pledged to them is really "the land,
trade, and personal industry of the subject," and these are "diminished in their true
value just so much as they are pledged to answer."

For Blackstone, a creditor’s property constitutes a demand on the debtor, and
when government is the debtor, the property consists of "a certain portion of the
national taxes," and however much he is enriched by this, the nation, which pays the
interest, is made poorer. Thus public debt does not create net national wealth. "The only
advantage that can result to a nation from the public debts," Blackstone insists, "is the
increase of circulation, by multiplying the cash of the kingdom," so "a certain proportion
of debt seems therefore to be highly useful to a trading people," yet "what that
proportion is, it is not for me to determine.” In fact, Blackstone goes further and declares himself “indisputably certain” that public debt is a net national harm, “that the present magnitude of our national encumbrances very far exceeds all calculations of commercial benefit, and is productive of the greatest inconveniences,” not only because of “the enormous taxes that are raised upon the necessaries of life for the payment of the interest of this debt,” which hurt the economy, but because the increase in money causes inflation, and that part of debt owed abroad cause wealth is exported to pay interest; if instead the public debt is mostly owed at home, it slowly ruins a nation’s economy because “the active and industrious subject” is taxed to pay interest to “the indolent and idle creditor.” Lastly, a large public debt “weakens the internal strength of a state, by anticipating those [tax] resources which should be reserved to defend it in case of war.”

Soon after Hume’s and Blackstone’s rather grim accounts of Britain’s public debts, another such account came from a writer who would become important for his subsequent influence on Alexander Hamilton, first as a young military officer and then as America’s first Treasury secretary in the 1790s. In 1757 Malachy Postlethwayt issued Great-Britain’s True System, with a sub-title that openly publicized his pessimistic theme: “Wherein is clearly shown that an increase of the public debts and taxes must, in a few years, prove the ruin of the monied, the trading, and the landed interests.” In time, Postlethwayt’s work would serve mainly as a warning to Hamilton about how not to handle public debt, for we know that eventually Hamilton became sanguine about it;
but we shall also observe how, on brink of war in 1774-1775, he would publish essays with projections of Britain’s pending insolvency. Hamilton got this from Postlethwayt.

A decade later, in 1767, now a quarter-century after Hume’s essay on public debt, came a more sophisticated and generally sanguine view of public debt, from Sir James Steuart (1713-1780), who is considered the last of the great mercantilist theorists. Yet Steuart endorsed constitutionally limited states, and unlike Hume, argued that they should always and honorably pay their obligations, as long as they were able to do so. In *An Inquiry into the Principles of Political Economy* (1767) Steuart also rejected Hume’s contention that public debts were a net burden to society or to its economic prosperity, as well as Hume’s claim that Britain somehow teetered on the brink of a national bankruptcy. Soon thereafter, and just prior to the arrival of Adam Smith’s famous book in 1776, sanguine views on public debt also came from Isaac de Pinto (in 1771) and Thomas Mortimer (in 1772). Yet whereas de Pinto and Mortimer are unvarnished optimists on public debt, Steuart is more measured and contextual – hence a realist.

According to Steuart (1767), “the principles which influence the doctrine of public credit are so few, and so plain,” that he is surprised to see them so frequently “plunged” into “obscurity.” But in the case of “a limited and free government” three requisites are “essential to the firm establishment of public credit.” (656) First, the people must be made to realize that the servicing of public debt will require some tax payments by them, hence a diminution of net income; second, the state must pledge to borrow
only for the public’s benefit; third, the state must gain the confidence of creditors, by keeping its promises and making rational provision for full debt service. Steuart was a major influence, later, on Alexander Hamilton, and we will soon see that Hamilton incorporated much of Steuart’s realism in his own views on public debt.

As a mercantilist, Steuart favors policies ensuring ample supplies of domestic cash (gold and silver), so he wants Britain to have a “positive” trade balance, with exports exceeding imports. This implies it must also be a net importer of foreign securities (i.e., a net exporter of savings, or capital), since by definition, the international “balance of [all] payments” requires that all trade surpluses be offset by a like sum of capital deficits. Of course, a capital deficit means that more capital flows out of a nation than flows into it, which also means, in turn, that the domestic nation (here, Britain) of primary concern to a mercantilist must make net purchases of the financial securities (including the public debts) that are issued by foreign nations (which themselves run trade deficits).

Mercantilists like Steuart want to see an ample supply of money and a vigorous flow of cash and credit throughout the economy because they believe it stimulates commerce, trade, industry, and economic growth. Mercantilists view money as an exogenous factor in the economy, not an endogenous one; they fear that free markets will fail to create sufficient sums of money and credit, and in so failing will cause economic stagnation, typically accompanied by deflation and high interest rates. If
necessary, public policies should create ample supplies of money and credit.

Mercantilists also insist that interest rates reflect not the supply and demand for credit ("loanable funds") but instead the supply and demand for money; as such, they believe a greater money supply will (all else equal) lower interest rates, while a lesser supply will raise them, and lower interest rates are seen as better for the economy. For Steuart, and most mercantilists, a key benefit of public debt securities is their liquidity, or near-money status; they supplement the existing money supply, and instead of boosting interest rates, they tend to keep rates lower than they otherwise might be. Of course, Hume also said public securities were beneficial, at least to the extent they were liquid and near-monies, but he denied that this advantage out-weighed the hazards of public debt, and public debt that was ultimately insupportable was also necessarily less liquid, hence less advantageous. For Steuart, public debt had numerous other advantages, not the least of them being that it kept taxation to a minimum, which was good for the economy, all else equal; public debt was by no means a net national hazard, as long as the state established and kept inviolate a sinking fund to provide for servicing the debt.

Unlike Hume, Steuart has a high regard and respect for financiers and creditors; he views them as prudent and frugal actors, crucial savers who make possible investment, productivity, and prosperity. In contrast, prodigals and wastrels spend more than they earn and consume wealth instead of producing or accumulating it. Like Hume, Steuart believes the state, even when dependent upon capital markets, as a
public debtor, should be a nation’s sole sovereign, and must not sacrifice itself to any 
sub-class of society, including public creditors; yet unlike Hume, Steuart says a 
sovereign must never deliberately sacrifice or repudiate its creditors, despite their 
minority status. Steuart opposes public debt defaults and repudiations that arise not due 
to an understandable “necessity,” as when a sovereign is truly unable to repay a public 
debt, but out of mere “expediency,” when it is brazenly unwilling to do so.

Steuart (1767: 609) sees no inherent conflict between public debtor and creditor; 
he argues for grasping the right principles of public credit in order to discover “the 
methods for making them severally turn out to the best account not only for the state, 
considered as a body politic by itself, but also for the individuals which compose it.” The 
consequences of public debt, he says “can only be guessed at,” but he praises the 
handling of Britain’s public debt after the Glorious Revolution, during the reign of 
William III (1689-1702), because although the nation’s public credit “was then in its 
infancy,” nevertheless it was “set upon the principle of a free and limited authority, 
exercised by ministers of state, at all times responsible to Parliament at the risk of their 
heads, in case of any open violation of the public faith.” Steuart says the constitutionally-
limited state “is the best of all securities against the bad exercise of power,” (612) and 
further contends that “public faith stands upon the solid security of an honest 
Parliament.”(615) Yet “when credit is in a languid state, every expense of government 
must rise in proportion to the discredit of the paper with which they pay.” (619)
Steuart explains that despite Britain’s many wars during the first half of the 1700s, and the vast rise in its public debts, its credit remained unquestioned, and it continued to pay lower interest rates than governments on the Continent (less than 4%) because it established sinking funds to protect creditors and maintained the pound as good as gold. Again, we see Steuart as a realist who brings in the context of public debt – namely, the extent of public credit. High public debts, he argues, are perfectly serviceable so long as they are within credit capacity and well-managed, with public budgeting well-organized. “In one way or another,” he writes, “all [public] debts contracted will disappear, either by being paid, or by being abolished, because it is not to be expected that posterity will groan under such a load any longer than convenient, and because in fact we see no very old debts as yet outstanding, where interest has been regularly paid out of a fund which has remained in the possession of the state.” (636) Steuart argues that so long as commerce is kept vigorous, tax revenues can keep pace with higher debt service, and a state that maintains its credit can access fresh borrowings at low interest rates and apply the proceeds to repay old ones. This is a realist position.

Unlike Hume, who expects only degeneracy, sloth and political corruption from the class of financiers which grows up along with expansions in the issuance and trading of public debt (and in the financial sector generally), Steuart sees both virtuous and productive results. “We may easily conceive,” he writes, “that a monied interest, of a long standing, may have influence enough to produce a change upon the spirit and
manners of the people,” and in Great Britain specifically, he hopes and expects to see “the spirit of that nation is totally bent upon the support of public credit,” for “their commercial interest depends upon it.” (636-637) One of the “contingent consequences” of public debt, he says, is its contribution to a more vital commercial culture, and how “it may tend to influence the spirit of the people, and make them adopt the sentiments of the monied interest.” (639) Steuart welcomes the likelihood that a “monied interest” will rise in wealth and influence versus the traditional but entrenched “landed class,” because “the prosperity of the state stands upon a precarious footing” whenever “any one interest becomes too predominant.” Unlike Hume, who fears that Britain will become less sustainable as a nation the more it is dominated by what he believes are parasitical financiers, Steuart sees the financiers as productive citizens and worthy counter-weights to the still-disproportionately powerful landlord class. Yet there need be no class warfare. In Steuart’s view, “the firm establishment of public credit” will foster “reciprocal sentiments of good-will among the two great classes of people,” which tend to “preserve a balance between them.” (639)

Like Hume, Steuart appreciates the fact that the safety and security of public debt serves as liquid form of near-money, at least when it is not of long duration or over-issued, and that this in turn facilitates commercial activity. He names numerous other benefits of public debt. It augments a nation’s “permanent income,” he says, by eliciting investment of what otherwise would remain a private sector cash hoard. It counter-acts
commercial stagnation, by keeping funds circulating (via interest payments). As a mercantilist, Steuart believes problems arise only with public debt that is held abroad, for a nation must then export cash to pay interest and redeem principal.

Steuart, aware that his views on public debt are sanguine, and that many other political economists (Hume among them) are skeptical about debt, explores the potential limits of public debt – that is, when a nation might become insolvent. This is typical of the realist approach. Steuart asks “How far may debts extend?” and “How far may taxes be carried?” Above all, “What will be the consequence, supposing the one [taxes] and the other [debt] are carried to the greatest height possible?” (645) On the first question, Steuart contends that before public debt reaches its ultimate limit it “may be increased to the full proportion of all that can be raised for the payment of interest.” (646) As long as interest rates remain low and interest expense on the debt does not consume too large a share of the tax revenues, public debt may be safely increased. On the second question, Steuart he notes that Britain’s property tax rate is four shillings in the pound, or 4/20 (20%), and that Hume’s fear that it may reach 19 shillings in the pound (95%) is unfounded and alarmist. Britain’s current tax burden is not great, Steuart implies, nor is it likely to become so; thus the nation could support even higher levels of public debt than at present. Indeed, when Steuart wrote in 1767, Britain’s public debt totaled £130 million, or 141% of GDP; by 1800 the debt summed to £440 million, or 177% of GDP. Yields remained low, even as Britain’s debt ratio reached a record 259% in 1819;
but that high leverage preceded not a national bankruptcy but a century-long span of peace and prosperity, with budget surpluses and debt redemptions that gradually reduced the debt ratio to 100% in 1860 and just 25% on the eve of World War I in 1914.

Although Steuart believes it is important “to show where the constant mortgaging of a public revenue may end,” he also believes he can “disprove the vulgar notion that by contracting debts beyond a certain sum, a trading nation which has a great balance in its favor must be involved in an unavoidable bankruptcy. To say that a nation must become bankrupt to itself is a proposition which I think implies a contradiction.” (647) As a mercantilist always eager to see his nation’s exports exceeding its imports, and thus importing net sums of cash, Steuart cites this inflow as the basis for a liquid and robust economy that can, thereby, more easily service higher loads of public debt. In his view it is simply “not necessary that public credit should ever fall, from any augmentation of debts whatever, due to natives,” but surely “it must fall as soon as the nation becomes totally unable either to export commodities equal to all her imports and foreign debts, or to pay off a proportional part of the capital sufficient to turn the balance to the right side.” Thus “the most important object in paying off debts, is to get quit of those due strangers,” that is, foreigners. (654) Yet he still warns against a deliberate default on foreign debt-holders, for “to break faith with strangers” and to pursue such a “glaring scheme of treachery” will only stop the circulation of money and credit and cause “the ruin of industry.” (655) Steuart also
shadows Melon’s view that in the case of domestically-held public debt, we owe it to ourselves, and it cannot bankrupt a nation, but to owe public debts to others – foreigners – can indeed bring trouble. “The idea of a nation’s becoming bankrupt to itself, I have always looked upon as a contradiction; but that it may become bankrupt to the rest of the world, is quite consistent with reason and common sense.” (653) As of 1767 he says he is “very far from supposing the present situation of England to forebode the approach of any such disaster.” (654) Although a public debt realist, in this regard (externally-owed public debt), he is a pessimist, like so many other classical theorists.

Steuart by no means approves of a deliberate default on public debt. He will make “no argument to prove that a scheme of a public bankruptcy is either lawful, honorable, or expedient, if voluntarily gone into by a state,” for that is “diametrically opposite to every principle of good government.” But when a nation is not merely unwilling but unable to repay its debts, there is a “proper method of breaching faith,” and of “bringing credit decently to her grave when, after being overstretched, it can no longer be supported.” (648) A deliberate debt default would severely harm creditors, and since Steuart sees them as socially productive, others would also feel the pinch. “The creditors would then lose all, the trade of England would be undone, and the multitudes who live in consequence of the demand for their industry, from the one and the other, would be reduced to misery.” This differs from Hume’s approach, which welcomes public debt default and the sacrifice of a minority of what he sees as slothful,
parasitical creditors for the benefit of the millions compelled to pay taxes. For Steuart, the “multitudes,” engaged largely in physical labor, depend on financiers, merchants and entrepreneurs, not the other way around. A public debt default harms the multitudes that are a nation’s employees because, first and foremost, it harms their employers. Steuart says it is naïve and destructive to expect “that government shall find it expedient” to “use a sponge for the public debts,” and to “sacrifice the interest of all the creditors in favor of the whole body,” and to do so “without hurting any interest in the state, that of the creditors alone excepted.” (651) To advise “a total bankruptcy,” he concludes, “and abolition of taxes,” would necessarily “bring [Britain] back to the situation it was in before taxes and debts were known” – that is, bring it back to a poverty-stricken medieval age.

The best way for a government to service its debts, according to Steuart, is to make an on-going provision for them, by a sinking fund, or by borrowing by annuities, wherein not just interest but also a portion of the principal is repaid each year (instead of waiting to make a one-time, lump-sum payment at a distant maturity). Otherwise, if a nation is to default on its public debt it must only do so out of necessity and unavoidably, as a last resort, never deliberately or out of mere expediency, when it is still capable of paying something. Steuart closes his discussion with a brief list of eight ways an over-indebted state can reduce its public debts honorably, what he calls “fair and honest expedients which a state may employ to get rid of its debts, without any
breach of public faith, or without prescribing conditions of payments, which the creditors are forced to accept against their will.” (663) But the best time to reduce debt is in peacetime, he says, for “this is the golden opportunity for diminishing the public burden occasioned by debts.” (667) It is unwise to continue borrowing and accumulating public debts even in peacetime. This is a realist position.

In assessing Steuart’s contribution to public debt theory, Stettner (1945) classifies it as “enlightened optimism,” with “a stress on the continuous process of adaption to, and modification of, institutional factors that are in ceaseless flux,” to arrive at valid principles. It may be said that “enlightened optimism” about public debt is but another way of describing a realist position, whereas zealous and unqualified optimism is not. As a mercantilist, Steuart “sees it as the function of the state to draw stagnant funds out of hoards, via taxation or public borrowing and channel them into useful and productive government expenditures, thus ensuring that the income flow will complete its circuit.” (475-476) But if so, an ever-rising public debt implies an ever-larger pool of stagnant funds to be drawn out of hoards, implying an ever-more degenerate economy in need of perpetual government intervention and redistribution. That was not Steuart’s main view; he knew that public debts soared due to war, not to peacetime cash-hoarding.

Soon after Steuart’s book appeared in 1767, a case was made that public debts mainly enriched a nation, a position more optimistic than it is realistic. In 1771 a Dutch
Jew of Portuguese origin, Isaac de Pinto (1717-1787) issued, in French, the book that would appear later in English, as *An Essay on Circulation and Credit* (1774). Pinto wrote:

I say that the national debt has enriched the nation. . . . At every loan the government of England, by granting creditors the proceeds of certain taxes which are pledged to pay the interest, creates a new, artificial capital, which did not exist before and now becomes permanent, fixed, and solid. This capital, by the agency of credit, circulates to the advantage of the public as if it were an actual sum of money by which the state has been enriched. . . . [Monies borrowed in 1760] were spent in great part within the nation itself . . .[and] only the subsidies to other [foreign] states . . . were a pure loss. . . . The enormous sum which composes the national debt has never existed at one time; the magic of credit and of the circulation of money has produced this mass of wealth by successive operations with the same coins . . . Public funds are the magnets which draw money. . . . Reflect then on these principles – the nature, the essence, and the effects of public loans where properly made and employed. You will find that they effectively enrich the state and do not impoverish it, that they double the moneyed capitals, and consequently, the power of contracting more loans.

Pinto’s premise – that public borrowing and spending add to wealth – is a common premise among mercantilists, but a fallacy, because it forgets that in the exchange two sums are taken from the private sector while only one is returned to it by state spending. There is a net loss, not a net gain, for the private economy. Surely “the state has been enriched” by it, as Pinto notes, but the nation in its entirety cannot be. First, a sum goes to the state as a loan; second, the state spends the sum on goods and services; third, goods and services are sold to the state. Thus while two sums go to the state, only one goes to the private sector. Of course, the private sector is also left with an offsetting asset, a financial instrument or security, the government bond, but its value depends entirely on the state’s capacity to tax the private sector in the future, which is
only a deferred deduction from the nation’s wealth. Pinto is also careful not to assert that any kind of debt or debt load will suffice to perform what he calls the “magic” of credit creation; in a moment of question-begging, he says public loans enrich a nation only as long as they are “properly made and employed.” Presumably, those not properly employed do not enrich. This is the closest Pinto comes to a realist position.

Elsewhere in his 1774 book Pinto concedes that a state might “accumulate too great a debt,” but he does not specify ways to measure the limit of sustainable debt. He concurs with Steuart (and all other writers on public debt in the 18th century) that credibility in large state borrowings can only be sustained with the backing of a credible sinking fund, but he also contends that no public debt should ever be repaid materially or entirely, even in peace-time, and even with the aid of a sinking fund. Even if England could rid herself of all public debts she should not do so, Pinto argues, this rather curious advice flows straight from his view of the nature of public debt: to the extent its issuance means the creation of net wealth for a nation, extinguishing all or part of it necessarily entails a loss of net wealth nationally. At a time when England’s government owed £120 million, Pinto wrote that “it would be very harmful to [England] not to preserve at least £60 million of its artificial riches, the utility and necessity of which I have demonstrated.” Pinto seems untroubled by his frequent and contradictory resort to such phrases as “artificial capital,” or to credit which circulates “as if it were an
actual sum of money,” and others which seem to imply that newly-issued public debt does not, despite his claims elsewhere, create real, solid, or fixed wealth.

An Englishman who endorsed and expanded upon Pinto’s pro-debt themes, Thomas Mortimer (1730-1810), added the insight that it was a mistake even to repay public debts or to establish sinking funds, in his book, *The Elements of Commerce, Politics, and Finances* (1772). For Mortimer “public debt is a national good,” because “it raises us fleets and armies more expeditiously than the mint could coin the precious metals.”

(365) Again we find the idea that liquid public securities serve as near-money, wedded to the mercantilist notion that more money generates new tangible wealth. Recounting Britain’s brief experience with an “increase of paper credit,” Mortimer insists it has promoted “a general circulation of a new species of money, quickened industry and labor, and augmented not only the value, but the demand, for the produce of every art and manufacturer.” (380) Another advantage of debt finance amid war, he says is that “we avoid the tedious and oppressive modes [of fund-raising] formerly practiced here, and still subsisting in France, such as heavy capitations, or poll taxes, and monthly assessments on lands and personal property.”

Finally, Mortimer is critical and dismissive of Hume’s (1752) claim that either public debts must destroy a nation, or a nation must destroy its public debts. “This is the well-known postulate which has sounded the alarm to the whole [British] kingdom,” Mortimer complains, “and has propagated a general apprehension concerning the final
consequence of the national debt.” He says “every speculative projector, every
disappointed statesman, every pseudo-patriot, every timid or hypocondraical
adventurer in the public funds, and all the ruined gamblers in Change Alley, have made
[Hume’s “Of Public Credit] their common text, and have filled our ears with tedious
essays and declamations on the approaching bankruptcy of the state, in times of war
adding to its horrors, and in the halcyon days of peace, disturbing its repose, by their ill-
judged intimations. But we shall easily silence the disciples, if we are able to refute their
master [Hume].”(368) Mortimer, leaning heavily on Pinto, proceeds to try to refute
Hume’s pessimism on debt, his fears of inevitable national ruin, and his case for a
deliberate default, by conveying how well public securities have actually performed in
the marketplace, “notwithstanding all the declamations” of the pessimists. “Public credit
has outlived the gloomy prophecies of its bankruptcy,” Mortimer declares, “is in a more
flourishing condition at present than in any former time,” and “will support us
triumphantly in twenty future wars against the united powers of the house of Bourbon
[France], securing to us, likewise, our unrivalled commerce.” (366).

Given what came to pass, Mortimer was largely correct: Britain’s public debt sky-
rocketed amid the many wars it fought over the subsequent half-decade, through the
end of the Napoleonic wars (1793-1815), yet still performed well. Echoing the pro-debt
themes of Melon, Pinto, and Mortimer, within a decade Robert Peel, whose son (of the
same name) became England’s prime minister, published The National Debt Productive of
National Prosperity (1780). Its themes were no longer novel, nor argued more astutely than by predecessors, but it was important because it influenced the son, and was the last optimistic view of public debt that appeared in Britain for decades. Britain’s debt accumulated further amid war with the American colonies (1776-1783), and many more observers worried about its burden, suspecting Hume might be right after all.

On the eve of that war Adam Smith (1723-1790), in The Wealth of Nations (1776), railed against public debts (in Book V, Chapter III), on the grounds that it funded government spending, which itself was presumed to be non-productive and even a dissipation of wealth – a root assumption endorsed as well by subsequent political economists like Jean-Baptiste Say, David Ricardo, Robert Malthus, J.R. McCulloch, and J.S. Mill (although Malthus welcomed it as a way to absorb output “gluts”).

Only the last chapter of Smith’s monumental Wealth of Nations, the last in a nearly 1000-page book, treats public debt, so it receives perhaps less attention than Smith’s other theories (although Nicholson 1920 is an exception), and as such, also plays a lesser role in contemporary public debt debate. Yet Smith’s account of public debt is widely-held today (that is, popularly-held), as it is the pessimistic interpretation. Smith believes public debt “enfeebles” nations; he wishes Britain’s debt was extinguished, if necessary by higher taxes, even if that splits or shrinks the empire. Below we examine the main parts of his analysis.
First, Smith discusses the origins of public debt, next its economic effects and finally, the means of servicing and terminating such debt, whether by sinking funds and other means or by defaults, whether explicit or implicit (by inflation – what he calls a “pretended payment”). It is sometimes contended that Smith, as with all classical economists, believed in a tight analogy between private finance and public finance, that financial norms and rules for the household were as applicable to the empire, that each and all must live within his means. In this regard Smith is quoted as saying that “what is prudence in the conduct of every private family can scarce be folly in that of a great kingdom.” Indeed, that is Smith’s line, but it appears not in his discussion of public debt, but in Book IV, Chapter II of *The Wealth of Nations*, in the context of explaining the benefits of free trade and of finding good bargains. Yet he did believe in the analogy.

According to Smith no specific type of government tends to borrow, or borrow too much; monarchs and republics alike have done so. “The parsimony which leads to accumulation has become almost as rare in republican as in monarchical governments,” he says, noting how “the Italian republics and United Provinces of the Netherlands are all in debt,” an exception being the canton of Berne (Switzerland), but in general he finds that “the taste for some sort of pageantry, for splendid buildings . . . prevails as much in the apparently sober senate-house of a little republic, as in the dissipated court of the greatest king.” (861) Smith contends that “the practice of funding has gradually enfeebled every state which has adopted it,” starting in the Renaissance, with the Italian
republics (Genoa and Venice), and today they can only “pretend to an independent existence,” and “have both been enfeebled by it.” Spain, he says, learned from the Italian republics how to borrow, and it too has been “enfeebled,” having been deeply indebted even before the end of the 16th century, a century before England started borrowing publicly. France too, Smith says “languishes under an oppressive load” of debt, despite her vast natural resources; the Netherlands too is “enfeebled” by debt. (881) Smith offers dire predictions, given the public debts which had accumulated already by 1776, prior to the far-larger debts that would accumulate for all participants in the American revolutionary war (1776-1783) and during the Napoleonic wars (1793-1815). “The progress of the enormous debts which at present oppress, and will in the long-run probably ruin, all the great nations of Europe,” Smith writes, “has been pretty uniform.” He worries that states “have generally begun to borrow upon what may be called personal credit, without assigning or mortgaging any particular fund for the payment of the debt.” (863) States selectively dispense with sinking funds and other vehicles designed (since at least 1716) to ensure sufficient sums exist to repay principal at maturity; public borrowing becomes more tenuous. We know Smith believes public debts “enfeeble” nations; now we know he also believes they will likely “ruin” them.

In his chapter on public debt Smith complains frequently that public revenues are not sufficiently “liberated” from the need to pay principal and interest, suggesting at least an implicit critique of something like “debt slavery.” He certainly does not deny
that public debt is purchased voluntarily, that it bestows narrow benefits, or that better public credit is typically an asset of better-administered governments. “The security which [public debt] grants to the original creditor, is made transferable to any other creditor,” he tells us, “and from the universal confidence in the justice of the state,” it “sells in the market for more than was originally paid for it,” so the financier who makes money this way “increases his trading capital.” Creditors lend happily to a creditworthy state, such a state is pleased to borrow on such easy terms, and given “the facility of borrowing,” understandably its sees no need to save ex ante. The commercial society is unique because it is wealthier and accumulates large savings; as such, its government is “very apt to repose itself upon this ability and willingness of its subjects to lend it their money on extraordinary occasions.” (863) Smith does not identify the seeming paradox of the case he is making: that commercial (not martial) societies seem best-positioned to finance war-time ventures and thus to emerge from them victorious.

Yet Smith is chagrined that the governments in his time no longer generated budget surpluses in peacetime, for deployment in case of future war; instead, they simply borrow for war (if they can), because state spending in wartime is often four times the level of spending in peacetime. The absence of budget surpluses and public saving in peacetime, he writes, “imposes the necessity of contracting debt in time of war,” and taxes will not do the job in war, because they take too long to collect; a nation is at risk and must move (and finance itself) quickly. “An immediate and great expense
must be incurred in that moment of immediate danger, which will not wait for the gradual and slow returns of the new taxes. In this exigency government can have no other resource but in borrowing.” (861-862) Political leaders are also reluctant to fund war by taxation, not only because they cannot raise sufficient funds that way, but because taxes risk disloyalty and resentment at a time when loyalty and patriotism are needed. States borrow from a “fear of offending the people, who by so great and so sudden an increase of taxes, would soon be disgusted with the war,” and because “they are enabled, with a very moderate increase of taxes, to raise, from year to year, money sufficient for carrying on the war,” to raise “the largest possible sum” with “the smallest possible increase of taxes.” In this way no one really feels the financial pinch of war. “In great empires the people who live in the capital, and in the provinces remote from the scene of action, feel scarce any inconveniency from the war,” and in fact, enjoy “the amusement of reading in the newspapers [about] the exploits of their own fleets and armies,” forgetting the likelihood that when peace resumes their wealth and income will be “mortgaged for the interest of the debt contracted in order to carry it on.” (872)

The economic effects of public debt are, for Smith, uniformly deleterious, whether because they permit greater government spending, which he deems wasteful and unproductive, or because it is merely deferred taxes, which ultimately are paid only by trenching upon savings, capital accumulation, and the incomes of productive laborers. Smith rejects the claims of optimists like Pinto that public debts entail a net
addition to national wealth; they are by no means “the accumulation of a great capital superadded to the other capital of the country,” Smith remarks, nor are they “the means of which its trade is extended, its manufactures multiplied, and its lands cultivated and improved.” For Smith, the public debt optimist “does not consider that the capital which the first creditors of the public advanced to government was, from the moment in which they advanced it, a certain portion of the annual produce turned away from serving in the function of a capital, to serve in that of a [tax] revenue,” and shifted “from maintaining productive laborers to maintain unproductive ones, and to be spent and wasted,” “without even the hope of any future reproduction.” (877) As with most public debt pessimists, Smith asserts that no public goods or services can be productive. While he concedes that no net loss arises when the creditor trades his savings for a public debt security, he believes the funds go to an unproductive sector (the public sector), whereas previous to that it was (or could have been) invested in a productive one (the private sector). He assumes no private capital is un-employed; “all capitals” are devoted to “maintaining productive labor,” so if creditors had “not advanced this capital to government, there would have been in the country two capitals, two portions of the annual produce, instead of one, employed in maintaining productive labor.” (877)

For reasons that are not obvious, Smith insists that taxes and public debt have negative but quite disproportionate effects on a nation’s savings, capital stock, and prosperity: taxes impede future levels of savings and capital, but debt destroys existing
savings and capital. “When the public expense is defrayed by [debt] funding,” he writes, “it is defrayed by the annual destruction of some capital which had before existed in the country,” by diverting outlays from productive to unproductive labor. Some savings are preserved, he admits, when borrowing renders present taxation lighter than it otherwise would be, and amid public borrowing “the frugality and industry of private people can more easily repair the breaches which the waste and extravagance of government may occasionally make in the general capital of the society.” Yet such borrowing still “destroys “old capital.”(878) Eventually, he says, under “the pernicious system of funding” the public debt grows so large that taxes also must rise substantially, to pay principal and interest, and the resulting “multiplication of taxes” then “impairs as much the ability of private people to accumulate even in time of peace, as the other system would in time of war.” He rejects the notion that “in the payment of the interest of the public debt” “it is the right hand which pays the left,” and that “the money does not go out of the country,” for “it is only a part of the revenue of one set of the inhabitants which is transferred to another,” and “the nation is not a farthing the poorer.” Smith mocks this as a mere “apology” derived from “the sophistry of the mercantile system,” which assumes all the public debt is held by citizens domestically, which it is not; but even if it were, he says, “it would not upon that account be less pernicious.” (879) Perpetual diversions of wealth by what Smith calls “the constant practice of [a state] borrowing of its own factors and agents, and of paying interest for
the use of its own money,” are not merely innocuous, but destructive, like the acts of “an improvident spendthrift, whose pressing occasions will not allow him to wait for the regular payment of his revenue.” (865) Wealth-creation, in contrast, requires frugality – both privately and publically.

The ultimate harm of public debt, Smith says, lies in the fact that it aids and abets a “transfer from the owners of those two great sources of revenue, land and capital stock, from the persons immediately interested in the good condition of every particular portion of land, and in the good management of every particular portion of capital stock, to another set of persons (the creditors of the public, who have no such particular interest), the greater part of the revenue arising from either.” The “long-run” consequence of this wealth transfer, Smith argues, is “both the neglect of land and the waste or removal of capital stock.” Drawing on his view of self-interest as indispensable to assuming personal responsibility and wealth-creation, Smith worries that although a public creditor has “a general interest in the prosperity of the agriculture, manufactures, and commerce of the country,” nevertheless he has “no interest in the good condition of any particular portion of land, or in the good management of any particular portion of capital stock,” and indeed “has no knowledge of any such particular portion,” “no inspection of it,” and “no care about it,” so “its ruin may in some cases be unknown to him, and cannot directly affect him.” (880) According to Smith, a capitalist who is invested in a private venture cares to foster it, for his own profit; in contrast, an investor
in public debt does not care to (and cannot if he wished) foster a nation’s financial status. Consequently, private capital will ensure national prosperity, while public capital will undermine it. This is a pessimist, not realist, view of public credit and debt.

We have seen Smith assert, without much specificity, that public debts “enfeeble” nations and eventually “ruin” them. He provides no empirical estimates of maximum debt-load capacities or leverage tipping points, or even rules of thumb, but he offers anecdotal historical evidence of states that have defaulted on their debts, whether explicitly or implicitly, and the latter approach is, perhaps, the most relevant to contemporary times, since it is a resort to inflation. If a public debt cannot be paid in full or in part, a state can simply pay in less-valuable money, by creating more such money through its monopoly central bank. According to Smith, this way of handling excessive public debt entails “injustice,” “violence” and “treacherous fraud.” (885)

When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment. The raising of the denomination of the coin has been the most usual expedient by which a real public bankruptcy has been disguised under the appearance of a pretended payment. . . . A national debt of about a hundred and twenty-eight millions, nearly the capital of the funded and unfunded debt of Great Britain, might in this manner be paid with about sixty-four millions of our present money. It would indeed be a pretended payment only, and the creditors of the public would really be defrauded of ten shillings in the pound of what was due to them. The calamity too would extend much further than to the creditors of the public, and those of every private person would suffer a proportionate loss; and this without any advantage, but in most cases with a great additional loss, to the creditors of the public. If the creditors of the public indeed were generally much in debt to
other people, they might in some measure compensate their loss by paying their creditors in the same coin in which the public had paid them. But in most countries the creditors of the public are, the greater part of them, wealthy people, who stand more in the relation of creditors than in that of debtors towards the rest of their fellow-citizens. A pretended payment of this kind, therefore, instead of alleviating, aggravates in most cases the loss of the creditors of the public; and without any advantage to the public, extends the calamity to a great number of other innocent people. It occasions a general and most pernicious subversion of the fortunes of private people; enriching in most cases the idle and profuse debtor at the expense of the industrious and frugal creditor, and transporting a great part of the national capital from the hands which were likely to increase and improve it, to those which are likely to dissipate and destroy it. When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonorable to the debtor, and least hurtful to the creditor. The honor of a state is surely very poorly provided for, when, in order to cover the disgrace of a real bankruptcy, it has recourse to a juggling trick of this kind, so easily seen through, and at the same time so extremely pernicious. Almost all states, however, ancient as well as modern, when reduced to this necessity, have, upon some occasions, played this very juggling trick. (883)

It may surprise some contemporary advocates of limited government to learn that Adam Smith believes Britain’s budget deficits are best reduced not by spending cuts but by tax hikes, and that he advises higher taxes specifically on Britain’s provinces and colonies (887-899), even though, given their non-representation in Parliament, “this could scarce be done” “consistently with the principles of the British Constitution.” (887) Nevertheless, Smith hopes new taxes will go to “defraying the general expense of the empire, and towards paying the public debt,” that they “might be augmented every year by the interest of the debt which had been discharged the year before,” in a way “sufficient in a few years to discharge the whole debt, and thus to restore completely the
at present debilitated and languishing vigor of the empire.” (890) Smith even insists that higher taxes be imposed on the now-rebellious American colonies, despite anti-tax animosity there since 1765 and recent gun shots at Lexington-Concord in 1775. Such a policy is just, he argues, for it is merely due recompense for the £90 million expended by the British government to prosecute the Seven Years War (1756-1763), an effort that he says secured America’s borders from repeated invasion by the French and Indians. (899) If Americans had become “irregular and uncertain” in paying taxes, Smith says, it was not because they could not pay but because they would not do so, and only because they were “too eager to become excessively rich.” (896-897). He believes “a total separation from Great Britain” is “very likely,” unless America is fully integrated into the empire and, accordingly, taxed more. Ironically, Smith’s tax plan, which he thought might reduce Britain’s public debt, was being enacted already by Parliament in the decade before his book appeared in 1776, and it lead to a break and all-out war with America that only further boosted Britain’s debt, from £136 million (1776) to £238 million (1783).

3.4 The Early American Debate: Hamilton versus Jefferson

The early American debate on public credit and debt was triggered partly by the $77 million in debt incurred at home and abroad to help pay for the revolutionary war against Britain, and partly by the distinct political economy and philosophy of the Federalists, led by Alexander Hamilton (1759-1804) and the Anti-Federalists, led by Thomas Jefferson (1743-1826). Whereas Hamilton argued that all the major economic
sectors (agriculture, commerce, manufacturing, and finance) were productive and inter-dependent, Jefferson, influenced by the French physiocrats, insisted that only agriculture produced a net product, and that every other sector was dependent on farming and essentially parasitical. Hamilton concurred with Steuart that public debt served as a close substitute for scarce currency and represented capital, but he denied that it constituted additional wealth, warned against accumulations of it, and advocated its extinguishment. Jefferson opposed debt of any kind, private or public, and in the latter case, held specifically that no generation should ever be permitted to forward its debts to posterity. Hamilton believed that both assets and debts could be validly and morally bequeathed, as long as they entailed a positive net worth.

As discussed earlier, Postlethwayt’s 1757 book, *Great-Britain’s True System*, predicted that England’s public debt would soon ruin every key group – the monied class (financiers), the trading class (merchants), and the landed class (landlords). Hamilton, America’s first Treasury secretary, in the early 1790s, and her foremost theorist (and practitioner) of public credit and debt, read Postlethwayt’s works. Initially Hamilton seemed convinced of Postlethwayt dire assessment; eventually, Hamilton became sanguine about public debts. But in his revolutionary essays (1774-1775), he suspects that Britain is on the brink of financial bankruptcy:

As to [England’s] wealth, it is notorious that she is oppressed with a heavy national debt, which it requires the utmost policy and economy ever to discharge. Luxury has arrived to a great pitch; and it is a universal maxim, that luxury indicates the declension of a state. Her subjects are loaded with the most
enormous taxes. All circumstances agree in declaring their distress. [1774] . . . The national debt [of England] is now about one hundred and forty millions sterling – a debt unparalleled in the annals of any country besides. The surplus of the annual revenues, after paying the interest of this debt, and the usual expenses of the nation, is upon an average about one million and a quarter sterling, so that with all their present resources they would not be able to discharge the public debt in less than one hundred and twelve years, should the peace continue all that time. It is well known that most of the necessaries of life are at present heavily taxed in Great Britain and Ireland. The common people are extremely impoverished [and] totally unable to bear any new impositions . . . [A] war will take place in the course of a few years, if not immediately . . . and then, through the negligence of her rules, Great Britain, already tottering under her burdens, will be obliged to increase them till they become altogether insupportable, and she must sink under the weight of them. [1775]

As America’s first Treasury secretary (1789-1795), Hamilton was asked by Congress to submit various reports on the nation’s public finances, money, and economy. The most important were the Report on Public Credit (January 1790), the Report on a National Bank (December 1790), the Report on the Establishment of a Mint (January 1791), the Report on Manufactures (December 1791), and the final Report on Public Credit (January 1795). The framers of the U.S. Constitution already had given the federal government the power to “borrow Money on the credit of the United States,” to “coin Money” and “regulate the Value thereof” (Article I, Section 8), and stipulated that “All Debts contracted and Engagements entered into, before the Adoption of this Constitution, shall be as valid against the United States under this Constitution, as under the Confederation.” (Article VI).
To achieve these ends, Hamilton argued for five main principles and policies related to the debt – all $77 million of it (41% of GDP) – most of which was in default. First, he insisted that current bondholders be refinanced at full face value (par), not at the lower market price, to comply with original contracts; on the grounds of both justice and expediency he rejected critics’ wish that the U.S. discriminate between the initial bondholders (by paying them more) and current ones (by paying them less). In Hamilton’s view, a discrimination was both “unjust and impolitic,” “highly injurious” to bondholders, “ruinous to public credit,” and “a breach of contract” “inconsistent with justice,” and “in violation of the rights of a fair purchaser.” (Syrett & Cooke, Vol. VI, 73) Second, Hamilton proposed that the federal government assume all state debts (one-third of the $77 million), on the grounds that they were incurred for a common cause (independence and the revolutionary war) and that each state should begin on an equal fiscal footing; his plan for assumption would simplify the nation’s debts and preclude a destructive inter-governmental rivalry over tax sources. Third, Hamilton proposed a privately-controlled national bank to centralize tax collection, simplify debt service, and issue a uniform currency. Fourth, he proposed a bi-metallic dollar convertible into fixed weights of gold and silver, so as to preclude the issuance of paper money. Finally, Hamilton proposed sinking funds and tax revenues that would repay the public debt in a few decades.
Each of Hamilton’s five policy proposals was enacted into law by the U.S. Congress and President Washington in the early 1790s, and each helped stabilize and improve U.S. public finances that helped foster a robust economy sufficient to repay all U.S. public debt by 1835 – the first (and last) time such an achievement was accomplished without a repudiation by any major nation. Hamilton’s policies on public credit and debt were driven by his theories of each, to which we now turn. As we will see, Hamilton was a realist, through and through.

Hamilton’s most comprehensive account of public credit appears in his last report to Congress (issued in January 1795), amid clear signs of success for his five-year old plan – although he had also predicted that success. Here he summarizes the enormous benefits, moral and practical, of a solid and stable public credit:

Credit, public and private, is of the greatest consequence to every country. Of this it might emphatically be called the invigorating principle. No well-informed man can cast a retrospective eye over the progress of the United States, from their infancy to the present period, without being convinced that they owe, in a great degree, to the fostering influence of credit, their present mature growth. This credit has been of a mixed nature, mercantile, and public, foreign and domestic [but each] nourished all the parts of domestic labor and industry. Their united force, quickening the energies and bringing into action the capacities for improvement of a new country, was highly instrumental in accelerating its growth. Credit, too, animated and supported by the general zeal, had a great share in accomplishing, without such violent expedients as, generating universal distress, would have endangered that result, that revolution, of which we are justly proud, and to which we are so greatly indebted. Credit, likewise, may, no doubt, claim a principal agency in that increase of national and individual welfare since the establishment of the present government . . . There can be no time, no state of things, in which credit is not essential to a nation, especially as long as nations in general continue to use it as a resource in war. . . . [Let others contend that it would be] practicable at all to raise the necessary sum by taxes
within the year [that it would not exert a harmful degree of] distress and oppression [but none can conclude] that war, without credit, would be more than a calamity—would be ruin. But credit is not only one of the main pillars of the public safety; it is among the principal engines of useful enterprise and internal improvement. (Hamilton 1795, 387-388).

As early as 1780, before the end of the Revolutionary war, Hamilton wrote in a letter to James Duane (Syrett and Cooke, Vol. II) that once peace was attained a convention should be held to establish a new form of federal government with sufficient powers to tax, service debt, establish a national bank and coin sound money. The Continental Congress found it nearly impossible to secure tax revenues or war provisions from states; hence the resort to reckless borrowing and the printing of paper money. Hamilton understood the defects of the approach, but also that taxation was even less popular; the popular will tended to oppose sound public finance. “Free countries have ever paid the heaviest taxes,” he wrote to Duane, and “the obedience of a free people to general laws however hard they bear is ever more perfect that that of slaves to the arbitrary will of the prince.” A government in need of money must care at least as much about “monied men” as anyone. “Our new money is depreciating almost as fast as the old,” Hamilton wrote, because “the monied men have not an immediate interest to uphold its credit.” The only real solution is to “engage the monied interest immediately” in favor of a sound currency and public credit, “making them contribute the whole or part of the stock and giving them the whole of the profit.” Hamilton’s aim was not to privilege public creditors but to end their exploitation by a deadbeat state.
Hamilton’s early case for a national bank projected the favorable result that “it will promote commerce by furnishing” a “more extensive valuable medium,” in place of a mere nominal, depreciated and volatile currency, hence a trustworthy medium of exchange that would also not rob public creditors of the future sums due them. For Hamilton, a national bank should not be political, in the manner of today’s central banks. It should not issue paper money as a monopoly nor devote itself to monetizing public debt. His plan, ultimately approved as the Bank of the United States (1791-1811), envisioned a privately-owned and operated bank (with only 20% of its capital coming from government, in the form of public debt), which could not be leveraged more than 1:1, and which was to be specie-based (25% of capital). In his proposal for the Bank in December 1790 Hamilton acknowledged that some advocates wanted a bank that was owned by and run by government officials for the government’s benefit, but he opposed that idea. The Bank must not be co-opted by a deadbeat government. For many advocates of a national bank, he wrote, “considerations of public advantage” suggest their “wish” that it might be established “on principles that would cause the profits of it to redound to the immediate benefit of the State.” But the idea faces “insuperable objections,” among them that a politicized bank would prove abusive:

To attach full confidence to an institution of this nature, it appears to be an essential ingredient in its structure, that it shall be under a private not a public direction, under the guidance of individual interest, not of public policy; which would be supposed to be, and in certain emergencies, under a feeble or too sanguine administration would, really, be, liable to being too much influenced by public necessity. The suspicion of this would most likely be a canker, that would
continually corrode the vitals of the credit of the Bank, and would be most likely
to prove fatal in those situations, in which the public good would require, that
they should be the most sound and vigorous. It would indeed be little less than a
miracle should the credit of the Bank be at the disposal of the government, if in a
long series of time, there was not experienced a calamitous abuse of it. (Syrett,
Vol. VII, 331) The interdiction of loans [to] the United States, or any particular
State, beyond the moderate sum specified, or a foreign power, will serve as a
barrier to executive encroachments; and to combinations inauspicious to the
safety or contrary to the policy of the Union. (Syrett & Cooke, Vol. VII, 340).

In one of his more famous formulations, Hamilton held that “a national debt if it
is not excessive will be to us a national blessing; it will be a powerful cement to our
union.” He wrote this two years before the end of the war, in an April 1781 letter to
Philadelphia banker Robert Morris (who had just been named Superintendent of
Continental finances) spelling out his ideas for fixing the finances when peace arrived
(Syrett & Cooke, Vol. II, 635). Later this line would be truncated by critics to say merely
that “a national debt is a blessing,” making Hamilton seem an optimist on public debt or
even proto-Keynesian. In fact Hamilton was neither an optimist nor a pessimist but
instead a realist on public credit and debt. In certain circumstances (post-revolutionary
America) and with the relevant qualifiers (if the debt is “not excessive”), public debt
could be deployed as an asset. To show the world that this young nation both could and
would pay its debts honorably was a sign of strength, as was the confidence instilled in
public creditors. The union could be better cemented if public creditors, many of whom
would become framers at the 1787 convention, had a direct financial interest in the
success of a limited, law-abiding, contract-respecting government, and if the thirteen factious states were set on an equal fiscal footing by an assumption plan that removed all of their own debts. For Hamilton a heavy national debt resulting from a war of liberation, though not preferred, nevertheless need not be a demerit; it could be made to render good purposes. To Morris he wrote that the U.S. must “speedily restore the credit of the government abroad and at home,” for this would “induce our allies to greater exertions on our behalf” and would “inspire confidence in monied men in Europe as well as in America to lend to us.”

Hamilton’s 1781 letter to Morris explained how to calculate a nation’s money supply, taxable capacity, and public debt capacity, and how these related to the U.S. case. He sketched a complete financial plan that would eventually become his early plan as Treasury secretary a decade later. The aim, he wrote to Morris, is to “erect a mass of credit that will supply the defect of monied capitals and answer all the purposes of cash, a plan which will offer adventurers immediate advantages analogous to those they receive by employing their money in trade,” a plan that will “give them the greatest security the nature of the case will admit for what they lend, and which will not only advance their own interest and secure the independence of their country, but in its progress have the most beneficial influence upon its future commerce and be a source of national strength and wealth.” Only a national bank, a national money, and a fully-serviced public debt could achieve these ends. It was not enough to provide for debt
service; the debt must be serviced in valid money. “The only cure to our public disorders is to fix the value of the currency we now have,” Hamilton wrote, and “increase it to a proper standard in a species that will have the requisite stability.” Only when a nation’s money and public credit are sound can private banking and credit be sound, with the happy result that “industry is increased, commodities are multiplied, agriculture and manufactures flourish, and herein consist the true wealth and prosperity of a state.”

None of this is achievable, Hamilton insists, without appealing to the interest of the rich and public creditors. “No paper credit can be substantial or durable,” he writes to Morris, “which has not funds [a sinking fund] and which does not unite immediately the interest and influence of the monied men in its establishment and preservation.”

Hamilton believed that “men of property in America” need not be discouraged by wartime defaults on public debt, for they are “enlightened men about their own interest and would easily be brought to see the advantages of good plan.”

Securing his place as the mid-point realist among theorists who were either debt optimists and pessimists, Hamilton argued, in his 1781 letter to Morris, that both of these alternative types – types that can still be found among theorists today – are wrong:

Never did a nation unite more circumstances in its favor than we do; we have nothing against us but our own misconduct. There are two classes of men among us equally mistaken – one who, in spite of daily experience of accumulated distress, persist in a narrow line of policy and amidst the most threatening dangers fancy everything in perfect security; another, who judging too much from the outside, alarmed by partial misfortunes, and the disordered state of our finances, without estimating the real faculties of the parties, give themselves up to an ignorant and ill-founded despondency. We want to appreciate our true
situation and that of the enemy. This would preserve us from a stupid insensibility to danger on the one hand, and inspire us with a reasonable and enlightened confidence on the other. (Syrett & Cooke, Vol. II, 633)

Only from the realist perspective can we understand Hamilton’s claim that “a national debt if it is not excessive will be to us a national blessing.” His vision does not blindly extol public debt as some cure-all or commercial stimulant (as optimists contend), nor is it one that insists a nation faces inexorable ruin amid high public debt (as pessimists contend). The real facts of the case matter; context matters; and sound public finance must appeal to the self-interest of all relevant parties, with none sacrificed or coerced. The U.S. public debt was a good in that it helped pay for the war of independence; it need not become a millstone around the neck of the new nation; if it is rehabilitated and reconstituted in an honorable and practical way, public credit and reputation can be enhanced, and redound to the nation’s long-term benefit.

Hamilton’s realism on public debt is best understood when we juxtapose his first and last reports to Congress. In the first report (January 1790) he stresses the benefits to be had from fixing a shaky debt structure; in the last report (January 1795) he warns against excessive public debt and shows how it can be eliminated in just three decades.

In Hamilton’s 1790 report, after recounting the economic advantages of a sound public credit and money of stable value, he reminds critics that his plan is not the cause of the public debt, for “it was the price of liberty,” “the faith of America has been repeatedly pledged for it, and with solemnities, that give peculiar force to the
obligation,” and given what was pledged on the debt in Article VI of the Constitution, “a
general belief, accordingly, prevails, that the credit of the United Sates will quickly be
established on the firm foundation of an effectual provision for the existing debt.”

(Syrett & Cooke, Vol. VI, 68) In the same vein, writing to President Washington in 1792,
Hamilton argues that “the public debt was produced by the late war” and “it is not the
fault of the present government that it exists; unless it can be proved, that public
morality and policy do not require of a government an honest provision for its debts.” In
paying its debts, he argues, the U.S. not only will “preserve the public faith and
integrity” but “manifest due respect for property,” for the public securities of creditors
are “as much their property as their houses or their lands their hats or their coats.”
Already he was thinking of a time when the public debt might be repaid in full. “It is the
merit of the funding system to have reconciled three important points – the restoration
of public credit – a reduction of the rate of interest – and an organization of the debt
convenient for a speedy extinguishment.” (Syrett & Cooke, Vol. XII, 229, 235, 242)

Also in his 1790 report, Hamilton stresses that “the maintenance of public credit”
can only be achieved “by good faith, by a punctual performance of contracts,” for
“states, like individuals, who observe their engagements, are respected and trusted,”
while “the reverse is the fate of those who pursue an opposite conduct. Every breach of
the public engagements, whether from choice or necessity, is in different degrees hurtful
to the public credit.” An enlightened policy appeals to its most enlightened supporters.
Hamilton is intent on having a voluntary restructuring of U.S. debt and securing a lower borrowing rate that nevertheless appealed to creditors because repayment was now more certain. Instead of exploiting public creditors, Hamilton treats them respectfully. “Those who are most commonly creditors of a nation,” he wrote, are “enlightened men,” and “there are signal examples to warrant a conclusion that when a candid and fair appeal is made to them, they will understand their true interest too well to refuse their concurrence in such modifications of their claims as real necessity may demand.” (Syrett & Cooke, Vol. VI, 68) Hamilton thereby can replace public debt paying 6% with debt paying roughly 4 ½%. The “fundamental principles of good faith,” he argues, “dictate that every practicable exertion ought to be made, scrupulously to fulfill the engagements of the government,” that “no change in the rights of creditors ought to be attempted without their voluntary consent,” and such consent “ought to be voluntary in fact as well as in name,” and “every proposal of a change ought to be in the shape of an appeal to their reason and to their interest,” “not to their necessities.” This is Hamilton the realist. In any debt restructuring creditors must receive an un-coerced “fair equivalent” with no default, either explicit or implicit. (Syrett & Cooke, Vol. VI, 88)

For Hamilton, all “enlightened friends of good government” should support credible public borrowing, and he named the “great and invaluable ends to be secured by a proper and adequate provision” for support and repayment of the public debt, including that it would “justify and secure the confidence” [of the friends of good
government], promote the increasing respectability of the American name,” “answer the calls of justice,” “restore landed property to its due value,” “furnish new resources both to agriculture and commerce,” “cement more closely the union of the states,” “add to their security against foreign attacks,” and “establish order on the basis of an upright and liberal policy.” But public funds must be set aside annually, from a budget surplus, in a secure sinking fund, to be used to stabilize the market value of public bonds and fully repay their principal at maturity. “The good effects of a public debt are only to be looked for when, by being well-funded, it has acquired an adequate and stable value,” for without this, the debt has “a contrary tendency.” Debt that is unfunded, precarious, and volatile invites wasteful speculation and undermines the economy; in such a condition debt will “destroy confidence” and cause a “pernicious drain of our cash from the channels of productive industry.” (Syrett & Cooke, Vol. VI, 70-71)

Hamilton’s theory of public debt is fundamentally misconstrued when it is characterized as being naïve or overly-optimistic, in the sense of a mercantilist or proto-Keynesian view of public debt. For Hamilton, it is not the public debt by itself that is a “blessing” but a debt properly managed and provided for, and to the extent it finances public goods crucial to preserving the safety and security of life, liberty and property, it is indispensable. Absent a rational provision for public debt – that is, a means of preserving its value and making punctual payments of its interest and principal, without burdening the economy – such debt might instead become a curse. Instead of
public debt providing a solid, enduring foundation for prosperity, it would be a quicksand threatening national solvency and sovereignty. Hamilton warns of this possibility in his last report to Congress (in January 1795), but the warning appears even in his first report to that body (in January 1790), again defying claims that he is an undiluted optimist on public debt:

Persuaded as the Secretary is that the proper funding of the present debt will render it a national blessing, yet he is so far from acceding to the position, in the latitude in which it is sometimes laid down, that “public debts are public benefits,” a position inviting to prodigality, and liable to dangerous abuse, that he ardently wishes to see it incorporated, as a fundamental maxim, in the system of the public credit of the United States, that the creation of debt should always be accompanied with the means of extinguishment. This he regards as the true secret for rendering public credit immortal. [The sinking fund should be applied to] the discharge of the public debt . . . until the whole of the debt shall be discharged. (Syrett & Cooke, Vol. VI, 106-107)

Unlike Steuart and the mercantilists, Hamilton does not view public credit as a net addition to national wealth, but nor does he concur with Hume and Smith that public debt entails a destruction of wealth, a diversion of capital from productive to “unproductive” uses. Hamilton is by no means a debt pessimist, as are Hume and Smith, and yet he is also a more consistent realist even than Steuart, in part because he is not truly a mercantilist. For Hamilton government need not be an unproductive entity; it should provide law, order, and peace, security for property, a national defense, and a minimum of infrastructure, all of which are valuable and a precondition for private
wealth creation. Moreover, government can and should borrow at times, especially in emergencies (wars) and when the assets resulting from borrowing pass to posterity.

Hamilton continues to counter-act the purely optimistic theory of public debt in his December 1791 report to Congress, even though its main focus is “the Subject of Manufactures.” (Syrett & Cooke, Vol. X, 277-282) Here he further distinguishes his view from those of mercantilists who contend that public debt is a net supplement to national wealth and the early classical economists who insist it entails the net destruction of national wealth. “Though a funded debt is not in the first instance an absolute increase of capital, or an augmentation of real wealth,” Hamilton writes, “yet by serving as a new power in the operation of industry, it has within certain bounds a tendency to increase the wealth of the community.” Nevertheless, he adds, we must always “estimate every object as it truly is” and “appreciate how far the good in any measure is compensated by the ill, or the ill by the good,” for “either of them is seldom unmixed.” This is the realist view of public debt. Hamilton then reiterates his warning against excessive debt:

Neither will it follow, that an accumulation of debt is desirable, because a certain degree of it operates as capital. There may be a plethora in the political, as in the natural body; there may be a state of things in which any such artificial capital is unnecessary. The debt too may be swelled to such a size, as that the greatest part of it may cease to be useful as capital, serving only to pamper the dissipation of idle and dissolute individuals; as that the sums required to pay the interest may become oppressive, and beyond the means, which a government can employ, consistently with its tranquility, to raise them; as that the resources of taxation, to face the debt, may have been strained too far to admit of extensions adequate to exigencies, which regard the public safety. Where this critical point is, cannot be pronounced, but it is improbable to believe that there is not such a point. And as the vicissitudes of Nations beget a perpetual tendency to the accumulation of
debt, there ought to be in every government a perpetual, anxious and unceasing effort to reduce that, which at any time exists, as fast as shall be practicable consistently with integrity and good faith. (Syrett & Cooke, Vol. X, 282)

This is the cautious element of Hamilton’s public debt theory that by now seems lost to the world after decades of selective citation and distortion. Hamilton’s theory acknowledges the existence of a “critical point” in public debt, in which it becomes excessive, and its servicing grows too dependent upon a burdensome tax system that undermines a nation’s prosperity, and indirectly, its public credit. This element of his theory holds that the cure for excessive public debt is to economize, or restrain state spending, and generate budget surpluses sufficient to reduce debt to more manageable proportions – preferably to extinguish it. Hamilton’s is not a theory that posits public debt as a precondition of prosperity, for to extinguish the debt would be to extinguish prosperity – and Hamilton welcomes the former, but not the latter. For Hamilton only spending restraint, not tax hikes, can fix an affliction of excessive public debt; the borrowing itself occurred because taxable capacity was at or near its limit, so the solution cannot be still more taxing. Nor is excess borrowing to be met still more borrowing, or by repayment in debased money (by inflation). In a 1792 report to Congress on means for securing the western borders from foreign attack, Hamilton writes that “nothing can more interest the national credit and prosperity than a constant and systematic attention to husband all the means previously possessed for extinguishing the present debt, and to avoid, as much as possible, the incurring of any
new debt.” Conceding that “great emergencies indeed might exist in which loans would be indispensable,” nevertheless, these must not be pretended emergencies. He notes that “taxes are never welcome to a community,” such that there is “too strong a propensity, in the government of nations, to anticipate and mortgage the resources of posterity, rather than encounter the inconveniences of a present increase of taxes.” More debt only defers taxes and imposes future burdens; to accumulate ever-more debt is policy of “the worst kind,” for “its' obvious tendency is, by enhancing the permanent burdens of the people, to produce lasting distress, and its natural issue is in National Bankruptcy.”

(Syrett & Cooke, Vol. XI, 141)

Hamilton’s most severe warnings against excessive public debt appear in his last report to Congress (January 1795), just before resigning as Treasury secretary. It is not as if the U.S. public debt has sky-rocketed under the Federalists’ reign; it has increased from $77.2 million in 1790 to just $80.8 million in 1794, but as a ratio to GDP it has declined from 41% to just 26%, and whereas interest expense on the debt was more than double federal revenues in 1790, it comprised just 64% of those revenues by 1794. Still, Hamilton wished to see a decline in public debt and slower spending; from 1790 to 1794 federal revenues had tripled, and totaled $17 million in those five years, but outlays grew faster, and totaled nearly $21 million in the same period. In his 1795 report Hamilton proposed to Congress “adoption of a definite plan for the redemption of the public debt, and to the consummation of whatsoever may remain unfinished of our
system of public credit, in order to place that credit, as far as may be practicable, on
grounds which cannot be disturbed, and to prevent that progressive accumulation of
debt which must ultimately endanger all government.” (Hamilton 1795, 345).

Hamilton was particularly insistent that Congress maintain the sinking fund
(first established in May 1792), and was worried that it might not be kept up or, indeed,
might be raided periodically out of political expediency, or as a way to avoid spending
cuts or new taxes. He reminded Congress that the Funding Act of 1790, which was based
on his first report to Congress, embodied the view that it was “desirable, by all just and
proper means, to effect a reduction of the public debt, and that the application of the
surplus revenue to that object will not only contribute to this desirable end, but will be
beneficial to the creditors of the United States, by raising the price of their securities, and
be productive of considerable saving to the United States.” (Hamilton 1795, 353). In
Hamilton’s view, all new public debt must be accompanied by means and measures
necessary to service and redeem it. To that end, “the inviolable application of an
adequate sinking fund is the only practicable security against an excessive accumulation
of debt, and the essential basis of a permanent national credit.” (Hamilton 1795, 375). If
the fund worked as designed, he says, the U.S. public debt could be fully repaid by 1825.

Yet Hamilton was suspicious of Congress, wary that it genuinely intended to
repay the public debt, or at least as quickly as he wished. The U.S. being no longer in a
fiscal swoon, thanks to Hamilton’s system, by the mid-1790s Congress was becoming
fiscally complacent, and insensitive about “the danger to every government from the
progressive accumulation of debt.” For Hamilton, an accumulating public debt is “the
natural disease of all governments,” but especially so of popular-elected governments
seeking to spare mindful voters from suffering spending cuts or tax hikes:

There is a general propensity in those who administer the affairs of 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. To extinguish a debt which exists, and to avoid
the contracting more, are ideas always favored by the public feeling and opinion;
but to pay taxes for the one or the other purpose, which are the only means of
avoiding the evil, is always more or less unpopular. These contradictions are in
human nature; and happy, indeed, would be the lot of a country that should ever
want men ready to turn them to the account of their own popularity, or to some
other sinister account. Hence it is not an uncommon spectacle to see the same
men clamoring for occasions of expense, when they happen to be in unison with
the present humor of the community, whether well or ill-directed, declaiming
against a public debt, and for the reduction of it, as an abstract thesis; yet
vehement against every plan of taxation which is proposed to discharge old
debts, or to avoid new, by defraying the expenses of exigencies as they emerge. . .
The consequence is that the public debt swells till its magnitude becomes
enormous, and the burdens of the people gradually increase till their weight
becomes intolerable. Of such a state of things great disorders in the whole of
political economy – convulsions and revolutions of government – are a natural
offspring. (Hamilton 1795, 372-373)

Hamilton then urges Congress to restrain its spending, secure the sinking fund,
and only thereafter, if necessary, raise additional taxes, but not to stand by and passively
permit annual deficits and an accumulating public debt. He declares that “there can be
no more sacred obligation” of a nation’s political leaders “than to guard with provident
foresight and inflexible perseverance against so mischievous a result” as a revolution
due to fiscal disorder. There is no better time than now (1795), he contends, to have political leaders “improving efficaciously the very favorable situation in which they stand for extinguishing, with reasonable celerity, the actual debt of the country, and for laying the foundation of a system which may shield posterity from the consequences of the usual improvidence and selfishness of its ancestors, and which, if possible, may give immortality to public credit.” (Hamilton 1795, 373). He believes human nature instills in politicians, especially in popularly-elected states, a selfish propensity to issue debt instead of cutting spending or raising taxes, and a myopic and dangerous tendency as well to selfishly impose un-chosen burdens (public debts) on future generations. As a realist, Hamilton presumes such innate “propensities” exert an influence, yet also appeals to Congress to courageously ignore or over-ride them. Wisdom must extend political leaders’ myopic self-interest and curb an abusive exploitation of public credit:

It is wisdom, in every case, to cherish whatever is useful, and guard against its abuse. It will be the truest policy of the United States to give all possible energy to public credit, by a firm adherence to its strictest maxims, and yet to avoid the ills of an excessive employment of it by true economy and system in the public expenditures, by steadily cultivating peace, and by using sincere, efficient and persevering endeavors to diminish present debts, prevent the accumulation of new ones, and secure the discharge, within a reasonable period, of such as it may be, at any time, a matter of necessity to contract. It will be wise to cultivate and foster private credit, by an exemplary observance of the principles of public credit, and to guard against the misuse of the former by a speedy and vigorous administration of justice, and by taking away every temptation to run in debt, founded in the hope of evading the just claims of creditors. (Hamilton 1795, 389).
We have seen in Hamilton, from the outset, in his early letter to Morris in 1781, and as late as 1795, in his last report to Congress, a concern neither to champion an aggressive resort to public debt, nor, on the other hand, to convince the public that public debt and creditors are a latent “evil” inevitably causing national “ruin.” Despite Hamilton’s wariness about of excessive public debt, by 1804, the year he died, the U.S. national debt was still $82 million, slightly less than in 1795, but only a mere 16% of U.S. GDP, compared to 22% in 1795, and interest expense on the debt absorbed only 36% of federal revenues in 1804, compared to 52% share in 1795. In 1835, only 40 years after Hamilton’s last report, and only a decade later than he predicted, the U.S. debt was zero.

Thomas Jefferson, Hamilton’s political nemesis, the U.S. Secretary of State from 1790 to 1793, and U.S. president from 1801 to 1809, abhorred all debt, private and public, as a form of slavery. Some scholars (Sloan 2001) attribute Jefferson’s hostile attitude to the fact that he lived his adult life over-indebted and in 1826, despite owning Monticello and over a hundred slaves, died a bankrupt, even as the U.S. government itself was on a path to becoming debt-free in a decade. But to assign Jefferson’s disdain for debt to his personal woes and animosities seems too facile; the same disdain for debt led others to avoid becoming indebted in the first place. Jefferson was born into the landed gentry of Virginia, became a Francophile and a physiocrat, and thus had theoretical-ideological reasons to despise debt and its many accoutrements – banking, finance, Wall Street, the “monied interest,” cities, and centralized government. As a Physiocrat Jefferson
believed, from an economic viewpoint, that net wealth came only from the soil, and
believed, from the moral viewpoint, that only an agrarian life preserves human virtue,
that only “those who labor in the Earth are the chosen people of God.” If true, and yet
non-agriculturalists, inferior in God’s eyes – merchants, manufactures, and financiers –
are found accumulating wealth, and worse, denying that planters have a valid property
right in human chattel, they must have exploited and extorted their wealth at the
expense of agriculturalists, at a cost to the genuine producers and the truly moral. For
Jefferson, debt of any kind (public or private) meant a dependency for the debtor, a lack
of freedom, a state not fully chosen; creditors thus were inherent predators, oppressors
of those who were lent capital but somehow could not return it in full, with interest.

Jefferson became famous by arguing for an American revolt against Britain in the
1770s, and drafted the Declaration of Independence in 1776, but he also opposed levying
the heavy taxes that were needed to fight the subsequent Revolutionary war, applauded
post-war debtor revolts (Shay’s Rebellion, 1786), opposed the founding of a federal
government in 1787-1788, and rejected each element of Hamilton’s plan to meet the
Constitution’s requirement of servicing and paying the national debt which had been
contracted during the war. As President in January 1802, only a year before committing
the U.S. to $12 million in further debt, to pay Napoleon $15 million for the Louisiana
Territory, Jefferson complained to du Pont de Nemours that “when this government was
first established, it was possible to have kept it going on true principles,” but that
Hamilton had “destroyed that hope in the bud,” and the U.S. could now “pay off his debts in 15 years, but we can never get rid of his financial system.” (Jefferson 1802) In fact, the U.S. could pay off its national debt in less than a generation, indeed, by 1835, despite the new debt incurred by Jefferson’s Louisiana Purchase (1803) and Madison’s war with Britain (1812-1814), largely because of Hamilton’s financial system. For Jefferson, U.S. debt somehow was caused by Hamilton – not by the political independence declared in 1776, not by the war, not by a Continental Congress unwilling to raise the taxes needed to fund the war, and not by Jefferson’s decision to have the U.S. borrow $12 million for the Louisiana Territory. By 1808 Jefferson was imposing an antagonistic embargo upon incoming British goods, during its war with Napoleon’s France, a move that eventually provoked the War of 1812 under his successor, a war which tripled the U.S. public debt to $127 million. Still, Hamilton’s financial system, reviled by Jefferson and Madison alike, made possible the repayment of all U.S. public debt by 1835, only a decade beyond the date Hamilton had predicted in 1795.

Jefferson’s theory of public debt reflected his belief in economic-moral superiority and primacy of agrarianism, that is – of physiocracy. His favorite political economist, Count Destutt Tracy (1754-1836), was a French aristocrat who held, in his Treatise on Political Economy (1817), translated by Jefferson, that public debt was inherently “evil,” that “in no case is it good to be in debt.” He rejected the view that “the loans of government are a cause of prosperity,” the notion that “a public debt is new
wealth created in the bosom of society,” and the claim that the present generation has “a right thus to burden men not yet in existence and compel them in future times its present expenses.” Tracy proposed that legislatures representing every new generation re-arrange and if necessary repudiate past public debts, to “modify, change and annul,” where expedient, and that “this evil” of public “would be destroyed at the root,” for money-lenders and capitalists, “having no longer any guarantee” of being repaid, “would no longer lend,” and thereby “many misfortunes would be prevented.” For Tracy, the problem was not excessive debt but any debt at all. “I maintain that the evil is not in the abuse of loans,” he writes, but “in the use itself of loans,” for “the abuse and the use are one in the same thing,” and “every time a government borrows it takes a step towards its ruin.” A private firm may legitimately borrow to invest in productive activity, but the state only consumes wealth, according to both Tracy and Jefferson, so if it borrows to do so it lacks the means to repay its debt.

Although a self-described “enemy” of public debt, Jefferson admitted, in a 1788 letter to the Commissioners of the Treasury, that it was crucial to national defense. “Though much an enemy to the system of borrowing, yet I feel strongly the necessity of preserving the power to borrow,” because “without this, we might be overwhelmed by another nation, merely by the force of its credit.” (Jefferson 1904, 6:423) Writing to George Washington that same year, Jefferson claimed to be “anxious about everything which may affect our credit,” hoped America might “possess it in the highest degree,”
but also that it would “use it little,” and he conceded, again, that “were we without credit, we might be crushed by a nation of much inferior resources, but possessing higher credit.” (Jefferson 1904, 6:453)

Despite Jefferson’s 1788 letters conceding that public debt is crucial to national defense, in his letter to James Madison, sent from Paris in September 1789, a few months after the outbreak of the French Revolution, he argues for the inter-generational repudiation of public debts of excessive maturity. He insists that no national debt should ever persist, in duration, beyond the generation that initially incurs it, that such debts, like governments, constitutions, and laws, should expire automatically, every few decades. The validity of popular sovereignty, according to Jefferson, requires that the popular will decide anew, each generation, what are to be the laws, constitutions, finances, and property arrangements by which they live; otherwise, a generation is compelled to live under a government absent genuine consent, amid a social contract negotiated by now-dead ancestors. “The earth belongs to the living,” Jefferson wrote, not to the dead. “No man can by natural right oblige the lands he occupied, or the persons who succeed him in that occupation, to the payment of debts contracted by him,” and “what is true of every member of the society individually, is true of them all collectively, since the rights of the whole can be no more than the sum of the rights of the individuals.” (Jefferson 1984, 959-960).

The question, whether one generation of men has a right to bind another . . . is a question of such consequences as not only to merit decision, but place also
among the fundamental principles of every government. . . . [T]hat no such obligation can be transmitted, I think very capable of proof. I set out on this ground, which I suppose to be self evident, that the earth belongs in usufruct to the living; that the dead have neither powers nor rights over it. The portion occupied by any individual ceases to be his when himself ceases to be, and reverts to the society. . . . [Bequeathed estates transfer] not by natural right, but by a law of the society [and] no man can, by natural right, oblige the lands he occupied, or the persons who succeed him in that occupation, to the payment of debts contracted by him. For if he could, he might during his own life, eat up the usufruct of the lands for several generations to come; and then the lands would belong to the dead, and not to the living, which is the reverse of our principle. . . . [T]he earth belongs to each [successive generation] during its course, fully and in its own right . . . clear of the debts and encumbrances of [earlier generations]. . . . The conclusion then, is, that neither the representatives of a nation, nor the whole nation itself assembled, can validly engage debts beyond what they may pay in their own time . . . [T]he received opinion, that the public debts of one generation devolve on the next, has been suggested by our seeing, habitually, in private life, that he who succeeds to lands is required to pay the debts of his predecessor; without considering that this requisition is municipal only, not moral, flowing from the will of the society, which has found it convenient to appropriate the lands of a decedent on the condition of a payment of his debts; but that between society and society, or generation and generation, there is no municipal obligation, no umpire but the law of nature. . . . On similar ground it may be proved, that no society can make a perpetual constitution, or even a perpetual law. The earth belongs always to the living generation: they may manage it, then, and what proceeds from it, as they please, during their usufruct. They are masters, too, of their own persons, and consequently may govern them as they please. But persons and property make the sum of the objects of government. The constitution and the laws of their predecessors are extinguished then, in their natural course, with those whose will gave them being. This principle, that the earth belongs to the living and not to the dead, is of very extensive application and consequences in every country . . . (Jefferson 1984, 959-964)

In seeking to relate the inter-generational norms of bequest among individuals of a family to transfers among generations of a nation, Jefferson elides the fact that in common law no individual or legal entity, as an heir, is obliged to assume solely an
ancestor’s debts or negative net worth (when debts exceed assets). It is likewise with nations, for succeeding generations assume debts but also assets from predecessors, and unless a nation’s standard of living is in a secular decline, posterity will receive no net burden but rather the positive net worth of ancestors, even while inheriting debts along with assets. Jefferson seems to insist that only assets be passed on, and even then not by natural right but as a civil privilege; further, he appears to deny or evade the fact that public debts, in the form of investment securities, are themselves assets from the perspective of those who hold and own them. Even if Jefferson’s principle were accepted today, it would seem wholly inapplicable, for no government bonds have maturities beyond thirty years, and the average duration is closer to five years, a mere fraction of any generation’s duration. What “posterity” is burdened by a five-year public debt?

Moving even further from his 1788 concession to the need for national debt, in 1798 Jefferson wrote to John Taylor of his desire to forbid it constitutionally “I wish it were possible to obtain a single amendment to our Constitution,” he began, saying he “would be willing to depend on that alone for the reduction of the administration of our government,” and that by “an additional article taking from the Federal Government the power of borrowing.” Now he insists that war be fully funded by taxes. “I know that to pay all proper expenses within the year would, in case of war, be hard on us,” he admitted, “but not so hard as ten wars instead of one. For wars could be reduced in that proportion; besides that the State governments would be free to lend their credit in
borrowing quotas.” (Jefferson 1904, 10:64). Nearly two decades later, in 1816, Jefferson again wrote to Taylor, this time suggesting public debt was fraudulent: “I sincerely believe . . . that the principle of spending money to be paid by posterity under the name of funding is but swindling futurity on a large scale.” (Jefferson 1904, 15:23).

During Jefferson’s presidency (1801-1809) the U.S. national debt declined by nearly a third, from $83 million (17% of GDP) to $57 million (9% of GDP), despite an extra $12 million incurred to purchase the Louisiana Territory from France in 1803. The net debt reduction of $26 million was achieved by generating roughly $41 million in budget surpluses over the eight years. Spending was cut 8% but revenues increased 57%. In his first inaugural address (1801) Jefferson promised “the honest payment of our debts” and “sacred preservation of the public faith,” and in his second inaugural address (1804) he applauded the sustained budget surplus and promised “to apply such a surplus to our public debts as places at a short day their final redemption.” But his 1808 embargo and severe cuts in military spending left U.S. revenues and national security exposed, invited the war of 1812, and led to a rise in the U.S. public debt from $57 million in 1808 to $127 million in 1815. In 1813, writing to his nephew, son-in-law and Congressman, John Wayles Eppes, Jefferson, now a retired ex-president, endorsed the Hamiltonian insistence that every new public debt be matched by a tax-fed sinking fund to eventually extinguish the debt; now he spoke respectfully of creditors, that payments owed them should be “sacredly observed,” and that excessive, perpetual
debts could cause oppression, bankruptcy and revolution. But he also returned to his earlier theme that public debt was immoral and menacing, and lawfully may be repudiated:

It is a wise rule and should be fundamental in a government disposed to cherish its credit, and at the same time to restrain the use of it within the limits of its faculties, never to borrow a dollar without laying a tax in the same instant for paying the interest annually, and the principal within a given term; and to consider that tax as pledged to the creditors on the public faith. On such a pledge as this, sacredly observed, a government may always command, on a reasonable interest, all the lendable money of their citizens... warning to them and their constituents against oppressions, bankruptcy, and [their] inevitable consequence, revolution. But the term of redemption must be moderate, and at any rate within the limits of their rightful powers. But what limits, it will be asked, does this prescribe to their powers? What is to hinder them from creating a perpetual debt? The laws of nature, I answer. The earth belongs to the living, not to the dead. The will and the power of man expire with his life, by nature’s law. ... We may consider each generation as a distinct nation, with a right, by the will of its majority, to bind themselves, but none to bind the succeeding generation, more than the inhabitants of another country... Are [new generations] bound to acknowledge the debt [bequeathed by ancestors], to consider the preceding generation as having had a right to eat up the whole soil of their country, in the course of a life, to alienate it from them, (for it would be an alienation to the creditors,) and would they think themselves either legally or morally bound to give up their country and emigrate to another for subsistence? Everyone will say no; that the soil is the gift of God to the living, as much as it had been to the deceased generation; and that the laws of nature impose no obligation on them to pay this debt. ... [T]he modern theory of the perpetuation of debt has drenched the earth with blood, and crushed its inhabitants under burdens ever accumulating. ... In seeking, then, for an ultimate term for the redemption of our debts, let us rally to this principle, and provide for their payment within the term of nineteen years at the farthest. ... (Jefferson 1984, 1280-1286).

In one of his last efforts on the topic, writing to Samuel Kercheval in 1816, Jefferson reprised his initial hostility to public debt, suggesting it was akin to slavery,
where the rich are masters and people are serfs. Hamilton had said the U.S. public debt
of 1790 was the “price of liberty,” the means that helped defeat the British and found the
new nation. Hamilton said public creditors should be appreciated, not despised, and
their debts paid, not repudiated. But Jefferson reiterated his view that public debts only
impoverish, destroy liberty, and foster a war of all against all:

I am not among those who fear the people. They, and not the rich, are our
dependence for continued freedom. And to preserve their independence, we
must not let our rulers load us with perpetual debt. We must make our election
between economy and liberty, or profusion and servitude. If we run into such
debts, as that we must be taxed in our meat and in our drink, in our necessaries
and our comforts, in our labors and our amusements, for our callings and our
creeds, as the people of England are, our people, like them, must come to labor
sixteen hours in the twenty-four, give the earnings of fifteen of these to the
government for their debts and daily expenses; and the sixteenth being
insufficient to afford us bread., we must live, as they now do, on oatmeal and
potatoes; have no time to think, no means of calling the mis-managers to account;
but be glad to obtain subsistence by hiring ourselves to rivet their chains on the
necks of our fellow-sufferers. . . . Then begins, indeed, the war of all against all,
which some philosophers observing to be so general in the world, have mistaken
it for the natural, instead of the abusive state of man. And the fore horse of this
frightful team is public debt. (Jefferson 1984, 1400-1401)

Hamilton and Jefferson could not have been more opposite in their theories of
public debt and proposals for handling it, although Jefferson as president moderated
and contradicted his views; nevertheless, while the framers and Hamilton called for the
paying U.S. public debts in full, Jefferson favored their repudiation. (Gunter 1991). There
seem reasonable grounds for considering a reversal of the usual interpretation of
Hamilton and Jefferson regarding public debt. Hamilton warns that public debt can
become excessive due to the popular form of government, and opposes both excessive
debt and excessive democracy. Jefferson, in contrast, opposes debt as such and favors
more popular government, even if it proves threatening to creditors’ rights. To the
extent the constituents of popular, democratic nations are prone to endorsing more
public spending but less taxation, they are also more prone to endorse deficit-spending.
Ironically, then, not the Hamiltonian but rather the Jeffersonian approach to government
may instigate, however unintentionally, unsustainable public debt accumulations.

3.5 The Late-Classical Debate: From Say to Ricardo, Mill and McCulloch

Hamilton and Jefferson’s views on public debt were shaped not only by personal
experience but also by the views of 18th century political economists, whether the
optimism of a mercantilist view or the pessimism of a classical view. Yet we have also
seen how Hamilton marked out a separate, unique position which was neither optimism
nor pessimism but realism about public debt – the view that its benefit or harm
depended on specific circumstances and conditions, and that good could result from
debt that was issued in the context of the rule of law and sanctity of contract, and in the
mutual self-interest of debtor and creditor alike. We have also seen how Jefferson’s
peculiar brand of pessimism about public debt reflected Physiocratic notions of value
and morals.

None of the 19th century classical economists – from Jean Baptiste Say (1767-
1832) to Karl Marx (1818-1883) – built on Hamilton’s realism, even though it was most
consistent with the empirical record. Public debt theory grew pessimistic again, even as Britain’s public debt peaked in 1819 and declined steadily over the subsequent century, both in absolute terms and as a portion of GDP, even as the U.S. public debt was extinguished by 1835, and even as government bond yields remained low, implying a safe investment, and hardly a leading indicator of national “ruin.” As public debt became less formidable and less important after the Napoleonic Wars (the U.S. Civil War was an exception) and over the course of the 19th century, political economists, instead of embracing realism, merely became less-vocal pessimists and ceased devoting chapters in their books to discussions of public credit and debt. Thus few treatments of public debt are found in the works of later-century neo-classical economists.

Despite the 19th century’s return to pessimism on public debt, a new feature of public finance emerged that would become crucially and chronically important for public debt in the 20th century and beyond – *viz.*, inflation, or the implicit (as opposed to the explicit) repudiation of public debt. Up to now (1790s) we have seen public debt theorists assuming debts are to be repaid in the same money they were initially incurred, in particular, in specie-based money that tended to retain its value over the duration of loans. Britain had been on the gold standard from 1714 to 1797, but went off it and issued a purely paper-based pound until 1821 (after which it returned to gold). The U.S. likewise was on a specie standard starting in 1792 – mostly silver until 1834 and gold thereafter – until it too suspended redeem-ability and issued purely paper-based
“greenbacks” at the start of the Civil War (until 1879, when it too, like Britain in 1821, resumed the gold standard). Of course, systems of pure paper money and their resulting tendency toward inflation were not unknown prior to the 19th century, but now, in the early decades of this century, more analytic minds assessed the interaction of such a monetary system with public debt, and many at least glimpsed that inflation harmed creditors and benefited debtors, that a moral hazard could arise when a public creditor becomes the monopoly issuer of pure paper money and can choose unilaterally and with impunity to inflate away its excessive debt burden. This feature of public finance is all the more relevant in our contemporary context, as the world’s monetary system is now solely paper-based, and no major currency in the world has been on any form of gold standard since 1971 (see Chapter 6, Section 5).

Like Hume and Smith, Jean Baptiste Say (1767-1832), in his treatise (Say 1803/1821, Chapter IX) contends that government spending is “barren consumption,” the destruction of wealth, even while conceding the state should provide national security, law courts, police protection, infrastructure and public schools. Do such services destroy wealth or are they its precondition? The latter, per Say. Yet he assumes that since all tax revenues and borrowed monies derive from existing income, savings and wealth, they constitute a plain taking of each. For Say, “public credit affords such facilities to public prodigality, that many political writers have regarded it as fatal to national prosperity.” He believes easy access to borrowed funds invites “financial
exhaustion,” not only by making war more likely, but by “making capital, which should be the fruit of industry and virtue, the prize of ambition, pride, and wickedness.” (Say 1803, 483) This mix of moral and economic elements often obscures Says’ main critique.

Say ridicules Melon’s claim that public debt is no burden because it is “no more than a debt from the right hand to the left,” and insists, in contrast, that with such debt “the state is enfeebled, inasmuch as the capital lent to its government, having been destroyed in the consumption of it by the government, can no longer yield anybody the interest it might earn.” By Say’s reckoning, “before the act of borrowing there will have been in existence two productive capitals, each of them yielding, or capable of yielding, a revenue,” consisting of that which is about to be lent to government and that which is retained in the private sector, and “after the act of [public] borrowing, there will remain but one of these capitals.” Public borrowing is effectively a zero-sum game, entailing no net addition to national wealth. Say concedes that public loans might support investments such as infrastructure, which yield productive benefits, but not on a net basis; the same capital left in the private sector could have done the same, or more.

Moreover, public borrowing, by supplementing the demand for loanable funds, raises interest rates, which raises costs to private sector borrowers. For Say, “national loans of every kind are attended with the universal disadvantage of withdrawing capital from productive employment, and diverting it into the channel of barren consumption; and in countries where the credit of the government is at a low ebb, with the further and
particular disadvantage of raising the interest on capital.” Say is a debt pessimist, insisting that there is no way to identify a net national benefit from public debt. “Great pains have been taken to find in the system of [public borrowing] some inherent advantage beyond that of supplying the public consumption,” he notes, but “a close examination will expose the hopelessness of such an attempt.” Public debt securities have value but are not wealth, he says, only a mere claim on future wealth (tax revenues). Public debt surely can render public creditors more loyal to a government, as Hamilton argued, but that too is no national advantage, in Say’s view of things.

Say concedes that public debt is a powerful weapon in war, and a more powerful agent than gunpowder, but also predicts that “probably the gross abuse” of it “will soon destroy its efficacy.” He admits that prices and yields on public securities can be taken as an objective index of market opinion about a government’s general reliability and creditworthiness, but punctuality in servicing public debts also can cloak wasteful and prodigal spending. For Say a public debt is perhaps a net national benefit if it provides a short-term outlet for funds that might otherwise be unemployed; “this is perhaps the sole benefit of public debt,” he concedes, but even this is dangerous, because “it enables a government to squander the national savings.” In Say’s view, “unless the principal be spent upon objects of permanent public benefit, as on roads, canals, or the like,” it is far better nationally “that the capital should remain inactive or concealed, since, if the public lost the use of it, at least it would not have to pay the interest.” For Say, it is
mainly lenders who benefit by public debt, by obtaining an artificially higher interest rate when government competes for a fixed and scarce sum of saving. “The whole community is the sufferer, with the sole exception of the capitalist,” he contends.

Oddly, despite Say’s almost unconditional rejection of public debt as a net national benefit, he applauds those governments best able to demonstrate a high public credit – that is, a high capacity to borrow. Paradoxically, he praises a great ability to borrow publicly, but not the actual exercise of such ability. Say defines public credit as “the confidence of individuals in the engagements of the ruling power, or government,” and believes public credit cannot be elevated unless government is constitutionally limited. Monarchs and autocrats are not able to secure high credit, he submits, for “where the public authority is vested in a single individual, it is next to impossible that public credit should be very extensive.” In contrast, “representative governments will acquire a marked preponderance in the scale of national power, simply on account of their superior financial resources.” (Say 1803, 482) As a pessimist, Say doubts that a high degree of public credit can be preserved without tempting states to prodigality and war; the public credit is prone to being exploited by borrowing, to some point of excess, presumably at or just beyond capacity. He agrees with other theorists that sinking funds can ensure a responsible policy of debt service, but if they work too well they only increase public credit (borrowing capacity), hence borrowing, and more often they are raided out of political expediency. In the end, Say agrees with Smith that public debt
tends only to accumulate and to end in national bankruptcy; he insists that England has engaged in a “scandalous abuse” of “the power of borrowing,” including “her substitution of paper-money in place of specie,” that is, her servicing of debt in false, not real, money – an implicit form of default.

Say, who would die a few years short of the year (1835), that the U.S. repaid all of its public debt, and in sound money, insisted, based on the history to date, that “national debts have never been extinguished except by a national bankruptcy.” (Say 1803, 486) Although Say denies that national debt is a net addition to national wealth, he also argues, with some inconsistency, that a default on national debt is destructive. A national bankruptcy “would probably obviate the necessity of fresh [public] loans,” which is a good thing, he says, but there would likely be no alleviation of high taxes, if debts have been incurred just to pay interest, and further, “the ruin of the public creditors would be attended with [an] abundance of collateral distress,” with “private failures and insolvency without end,” with “the loss of employment to all their tradesmen and servants,” and “the utter destitution of all their dependants.” Thus Say seems inconsistent in simultaneously denying that economic activity and inter-dependency might rest in part upon public credit, while also insisting it would all collapse if the value of public debt collapsed.

Perhaps the most succinct synthesis of classical public debt theory at the time was given by Sir Robert Hamilton (1816) in a monumental history of Britain’s public
debt published after the Napoleonic wars, and only a few years before Britain’s debt peaked at 261% of GDP. For Hamilton, the size of Britain’s debt is so “alarming” that no man can “foresee how far this system may be carried, or in what manner it will terminate.” (Hamilton 1816, 3). Insisting that “the portion of national income which can be appropriated to public purposes” was finite, he believes Britain is “already far advanced to the utmost limit,” without quantifying it. A nation understandably runs budget deficits and builds public debt in war, he argues, but in peacetime it should run surpluses sufficient to reduce debts nearly as quickly; he criticizes Britain for not having done so in the prior century. The result, “a perpetual increase of debt,” was now reaching “a magnitude which the nation is unable to bear.” For Hamilton “the only effectual remedy to this danger,” which, if ignored, “would terminate in bankruptcy,” is a lengthy period of peace, accompanied by frugality in government spending, and an increase of taxes. Britain already had instituted its first income tax in 1798, at a rate of only 10%, with a pledge to repeal it when the Napoleonic wars ended (a pledge kept, in 1816), and Hamilton believed 10% was about the maximum that possibly could be taken from British incomes. The subsequent century was, indeed, a relatively peaceful one, and as a result, on the eve of World War I, Britain’s public debt was but two-thirds of its level in 1816, and only 25% of GDP instead of 261%. But with hindsight we also know that 10% is hardly the upper limit to a modern economy’s taxable capacity.
Of all the contributions made by classical economists to the theory and analysis of public debt, perhaps none has been more over-rated than those of David Ricardo (1772-1823), especially regarding the doctrine of so-called “Ricardian equivalence,” which Ricardo himself never actually contended. (O'Driscoll 1977). This doctrine holds that there is no monetary difference between the effects of government spending when it is tax-financed versus when it is debt-financed, because debt is nothing but a deferral of taxes to the future, and if people were simply to discount future tax liabilities into the present, at the prevailing interest rate, they would find that they are equivalent in value to the taxes that would have to be levied in the present to pay for the same spending.

Ricardo’s real (and valid) point in discussing such calculations – a point that has been lost in the vast contemporary literature on Ricardian equivalence – is to stress that government spending itself is the real burden, that regardless of how it is funded, such spending deprives an economy of the saving, capital accumulation, and productivity gains necessary for long-term prosperity. In this regard Ricardo is, like Hume, Smith, and Say, a pessimist on public debt, but more deeply, a pessimist on government spending. Moreover, as mentioned, he does not himself believe in “Ricardian equivalence.” He does write that in theory, at least, the discounted present value of the future taxes required to service a new issuance of debt today, to fund a certain outlay, is identical to the full value of taxes if imposed today to fully fund the same outlay; but he also denies that taxpayers actually treat the two funding methods as identical, and
insists that they prefer the all-debt option, and because they exhibit such bias, Ricardo himself prefers the all-tax option, even in emergencies (like war). If people cannot afford a sudden, overwhelming boost in their tax liabilities, in emergencies, Ricardo says they should borrow personally, to meet them, so government itself may avoid the borrowing.

Ricardo also argues that if there is indeed a public debt, nevertheless it should not be provided for through a sinking fund, because either the fund would be properly-managed and lead to greater borrowing capacity, or mismanaged and misappropriated, which would impede the judicious retirement of debt. Nevertheless Ricardo insists that the public debt be redeemed in full and immediately, preferably by a capital levy – that is, by a large, one-time tax on property owners, including bond-holders, which might easily be interpreted as a direct confiscation of wealth or an outright default on public debt. In the meantime, writing in an era when the Britain was off the gold standard (1797-1821), Ricardo, despite being an advocate of the gold standard, proposes that the pound be backed by public debt – a radical precursor to the widespread organization of debt into currency that would come to predominate in the 20th century, an age when most of the world’s major nations would abandon gold-based money in favor of purely fiat paper money backed mainly by government debt.

On public debt, the significance of Ricardo’s theory is not, as contemporaries insist, that he posited an equivalence between an all-tax and all-debt funding approach, for he actually denies that any such thing is operative in the real world, but that he sees
public debt as uniformly detrimental, and worse perhaps, as justifiably confiscated or repudiated by the state, even though an asset and property right of public creditors, and yet also an asset worthy enough to back a nation’s currency when it was expedient for the state to jettison the gold standard and spend without limit by monetizing public debt. There is more to Ricardo’s public debt theory than mere “equivalence,” especially because it is at least as radical (anti-capitalist) as Marxian public debt theory. Thus quite apart from Ricardo’s belief in the labor theory of value, in an inverse relationship between wages and profits, in a secular decline in the rate of profit, and in the harmful effects of introducing labor-saving machinery, his pessimistic beliefs and punitive prescriptions regarding public debt also may have contributed to the curious phenomenon of “Ricardian socialism” that began in the 1820s, long before Marx arrived on the scene in the 1840s. On public debt, Ricardo’s influence on Marx occurred through Piercy Ravenstone, whose Thoughts on the Funding System and Its Effects (1824) was cited glowingly by Marx in Chapter XXI of his Theories of Surplus Value (1861-1863).

Remarkably, given the context, Ricardo devotes little space to public debt in Principles of Political Economy and Taxation (1817), even though Britain’s public debt had tripled during the Napoleonic wars (1792-1815), and had more than doubled as a portion of GDP, to 261%. In one passage Ricardo complains that “the mischievous policy of accumulating a large national debt” and “consequently enormous taxation” renders public finances “extremely artificial.” (Ricardo 1817, 241-242). He worries that the heavy
taxes needed to service debt will sap savings, capital accumulation, and productivity gains, thus long-term wealth-creation, yet he also agrees with Melon (1734) that interest paid and received cancel out, with no aggregate ill effects.

In a passage that would be characterized, decades later, as his “equivalence doctrine,” Ricardo explains that the cost of taxes paid in full, today, is equal to the present value of borrowing a like sum and repaying it over time with interest. But as mentioned, his aim is to show that the real burden on any economy is not taxes or debt per se but government spending, which adds nothing to output – and this spending burden is made worse, ne insists, if financed by debt than taxes. (Ricardo 1817, 245) “It is by the profuse expenditure of government, and of individuals, by loans,” he elaborates, “that the country is impoverished” and “every measure, therefore, which is calculated to promote public and private economy,” viz., less consumptive spending and more saving – “will relieve the public distress.” For Ricardo “it is not, then, by the payment of the interest on the national debt, that a country is distressed, nor is it by the exoneration from payment that it can be relieved. It is only by saving from income, and retrenching in expenditure, that the national capital can be increased.” (Ricardo 1817, 246) Endorsing the typical classical prescription, Ricardo insists that “during peace our unceasing efforts must be directed towards paying off that part of the public debt which has been contracted during war,” and to this end a nation might even justifiably make a “sacrifice of any part of its property which might be necessary to redeem its debt” in full, if
necessary by means of a one-time capital levy on the rich, a plan already proposed a
century earlier (he notes) by Archibald Hutcheson (1714). Yet, he fears, Britain’s leaders
have “neither wisdom enough, nor virtue enough, to adopt it.” (Ricardo 1817, 248)

Like other theorists, Ricardo believes in limits to how much a nation can borrow
publicly, but does not quantify them. He worries that if war should return, without
Britain having reduced her debt in the meantime, she might have to “submit to a
national bankruptcy.” Ricardo does not say Britain will be “unable to bear any large
additions to debt,” for it is “difficult to set limits to the powers of a great nation,” but he
is quite sure “there are limits to the price, which in the form of perpetual taxation,
individuals will submit to pay for the privilege merely of living in their native country.”
(Ricardo 1817, 249). He fears high debt will lead to a tax burden that causes an out-
migration of labor and capital.

Ricardo is best classified as a pessimist on public debt. There is little to no
defense of it, other than a concession of its convenience in financing war effort, and even
here he wishes war to be funded solely by taxation, for many reasons, not least that it
would make wars less likely, less costly, and less lengthy. If people cannot pay the taxes
necessary to fund a war they should borrow personally or, if necessary, sell their
property. In a series of letters written over a decade to various pamphleteers on public
debt, Ricardo’s pessimism is unvarnished. In 1815, as the Napoleonic wars were ending,
he complained of “the disadvantages we labor under from the pressure of our enormous
debt,” and confessed that every day he was “becoming a greater enemy to the funding system,” with its “evils” and “injurious” effects, among them high tax burdens and market distortions. (Ricardo 1811-1823, 13) In a letter from 1819 he proposed that Britain’s public creditors be paid only the market value of their securities, at the time 30% below the par value which had been contracted. (Ricardo 1811-1823, 70). Alexander Hamilton rejected such policy as an unjust breach of contract, as he did Ricardo’s suggestion that the principal and interest on public debt securities be taxed. In 1820 Ricardo went so far as to wish that public debt be ended and prohibited. Regarding Britain’s national debt,” he wrote, “I would pay it off entirely and never allow any new debt, on any pretence whatever, to be contracted.” (Ricardo 1811-1823, 110)

Ever the pessimist on public debt, Ricardo states unequivocally, in his “Essay on the Funding System” (1820), that it is “one of the most terrible scourges which was ever invented to afflict a nation.” (Ricardo 1820, 546) His aim in the essay is to present the theory and practice of sinking funds in British financial history. One might suspect that such funds, the aim of which is to ensure the efficient and honorable servicing of public debts, would gain Ricardo’s unmitigated endorsement, but he roundly criticizes them as prone to political abuse, to underfunding and opportunistic raids, and even when they are well-funded and properly administered, they provide a false sense of financial security that makes government borrow still more. This essay also includes an elaboration of the so-called “equivalence” Ricardo finds between funding by taxes or by
debt (Ricardo 1820. 539-542), but again, he denies that people, in fact treat the two similarly. The two burdens are “precisely of the same value” mathematically, “but the people who pay the taxes never so estimate them, and therefore do not manage their private affairs accordingly.” We are, he goes on, “too apt to think that the war is burdensome only in proportion to what we are at the moment called to pay for it in taxes, without reflecting on the probable duration of such taxes.” Thus “it would be difficult to convince a man” that the two ways of payment were “equally burdensome.” (Ricardo 1820, 539).

Ricardo maintains that to fund government spending, especially at high levels, as during wartime, by borrowing and repaying it over time, at interest, is viewed by most people as less burdensome than paying for it all at once in taxes. Indeed, the bias in favor of debt is so great, as is Ricardo’s fear of the way public borrowing saps savings and capital accumulation, that he advises an all-tax policy, even in wartime. He concedes that taxes also sap savings and capital, but most income is consumed, not saved, so taxes inflict less harm than does debt. “This argument of charging posterity with the interest of our debt, or of relieving them from a portion of such interest, is often used by otherwise well-informed people, but we confess we see no weight in it.” (Ricardo 1820, 539) As a result, he concludes, “war-taxes are more economical, for when they are paid, an effort is made to save to the amount of the whole expenditure of the war, leaving the national capital undiminished,” whereas with debt-financed spending
“an effort is only made to save to the amount of the interest of such expenditure,” not also to repay future principal owed, and thus “the national capital is diminished in amount.” (Ricardo 1820, 540) In short, Ricardo denies the existence of what scholars today deem “Ricardian equivalence.” Instead he posits what is now call “fiscal illusion,” with tax-payers biased in favor of debt. Further, he says more will be saved, to pay current taxes, than to repay future debts, while most scholars today contend the reverse.

Perhaps the most important yet least-examined aspect of Ricardo’s public debt theory is his proposal for public bonds to supplement gold and sterling silver as backing for Britain’s currency – in his “Proposals for an Economical and Secure Currency.” (Ricardo 1816) Britain had been on the gold standard from 1714 to 1797, but suspended convertibility during the Napoleonic wars; resumption occurred in 1821. Ricardo wrote mostly during this unique quarter-century (1797-1821) when Britain issued irredeemable paper money and massive new sums of public debt, and suffered the chronic inflation, price instability, booms, busts, and speculations that tend to accompany such schemes. The system shared many features of contemporary public finance.

Ricardo remained a resolute defender of the gold standard, even amid its suspension, and insisted in this period that the Bank of England was the sole source of inflation (in his 1811 essay, “The High Price of Bullion a Proof of the Depreciation of Bank Notes”), but he also sought other ways to stabilize the value of money. His proposal to back the British pound with public debt foreshadowed the more
nationalistic monetary systems that would follow, including the U.S. “free banking” era (1837-1861), the U.S. national banking system (1863-1912), and the U.S. Federal Reserve system (1913-present). Unbeknownst to Ricardo, perhaps, debt-backed currency would prove less stable than gold-backed currency, but it also paved the way for an eventual, widespread monetization of public debt, a mechanism for boosting the demand for it and also for implicitly defaulting on it (by inflation). In the mid-19th century Charles Holt Carroll (1799-1890) identified this as the “organization of debt into currency” (Carroll 1964) and saw it as a source of instability, especially when debts were illiquid, issued for consumptive (versus productive) purposes, and public instead of private.

Next to Ricardo, Robert Malthus (1776-1834) was perhaps the classical economist whose public debt theory would prove most relevant to contemporary theory, primarily because of his significant influence on John Maynard Keynes (1883-1946). As documented by Dome (1997, 2004) and Churchman (1999), Malthus was a “general glut” theorist who rejected Say’s Law and argued that aggregate supply and aggregate demand were rarely equal. More often than not, he argued, total supply exceeded total demand, resulting in an excess of output and saving, an overall deficiency of demand and consumption, and a deflationary unemployment. On the other hand, when total demand exceeded total supply, resulting in a generalized shortfall of output and saving, coupled with excess demand, the result was inflation. Although Hume, Smith, Say and Ricardo denied that general gluts were logically possible, they also believed government
spending tended to be more consumptive than productive and that public borrowing, far more than taxes, tended to absorb an economy’s savings. Only on the latter point did Malthus agree, but then used it to specifically condone deficit financing and accumulations of public debt as a “cure” for general gluts. He acknowledged that the policy would use up wealth, but said that was exactly what was needed amid excessive wealth. A century later Keynes also would reject Say’s Law, claim a general glut was possible, and endorse deficit-spending as a remedy for aggregate unsold output and mass unemployment.

By the 1840s Britain was two decades into what would become a long-term trend of public debt reduction, both in absolute terms and relative to GDP, and the U.S. had demonstrated an ability to entirely repay its public debt (in 1835). When Alexis de Tocqueville (1805-1859) wrote Democracy in America (1835/1840) he paid little attention to public debt. Yet he presented a hypothesis that drew upon ideas of the classical economists and is relevant for contemporary times: that popular forms of government (especially democracy) entail more extravagant government spending and a public financing system that relies far more on debt than taxes. In Chapter 5 of Democracy in America (1835/1840), in a section titled “Of Public Expenses under the Dominion of American Democracy,” Tocqueville argues that when one compares a “democratic republic and an absolute monarchy,” one will find that “public expenditures in the first are more considerable than in the second,” indeed, that state spending is more “lavish”
under democracy, and not only in America for “this is the case in all free states, compared to those that are not free.” Public spending under democracy also can be more wasteful, because unplanned and prone to discontinuance. “As the democracy frequently changes views and, still more frequently, changes agents, it happens that enterprises are poorly conducted or remain incomplete. In the first case, the State makes expenditures disproportionate to the grandeur of the end that it wishes to achieve; in the second, it makes unproductive expenditures.” Despite such dissipation, democracies are not more inclined to bankruptcy, he says, because as free nations they are also more productive and wealthier than un-free ones; as such, they exhibit a greater capacity for taxation. He does not stress that this greater taxable capacity also makes a nation more able to borrow (creditworthy), and that freer nations, to the extent they abide more by the rule of law, are also more trusted by creditors. Also, in these passages Tocqueville blithely assumes that democracy is co-extant with liberty; elsewhere, he famously warns that democracy may entail a “tyranny of the majority,” albeit more a tyranny of cultural convention and conformity of opinion than an actual, politically-coercive tyranny.

For Tocqueville, the poor and those in the lower-middle class outnumber those in the upper-middle class and the rich, and the majority is induced by leaders to use their voting power to elect greater government spending that the minority of citizens is forced to pay for. “Countries in which the poor would exclusively be charged with making the law,” says Tocqueville, “could not hope for great economy in public
expenditures,” for these “will always be considerable, either because taxes cannot reach those who vote, or because they are fixed so as not to reach them.” Consequently, “the government of democracy is the only one in which the one who votes the taxes can escape the obligation to pay them.” A future trend toward universal suffrage, he adds, will nearly guarantee profligate public spending, and by implication, deficit-spending, as taxes, will not be popular. Tocqueville also cites the history of democracy as a guide. “The unfortunate influence that popular power can sometimes exercise over the finances of the State made itself clear in certain democratic republics of antiquity,” he writes, “in which the public treasury was exhausted to help indigent citizens, or to give games and spectacles to the people.” The democratic bias towards public profligacy might be mitigated, Tocqueville suggests, if wider voting eligibility is accompanied by a wealthier populace. “The profusions of democracy,” he contends, “are less to be feared the more people become property owners,” because “on the one hand, the people have less need for the money of the rich and, on the other hand, they encounter more difficulties establishing a tax that does not hit them.” Here we see Tocqueville assuming, as would Karl Marx only a few years later, that one’s economic class and status necessarily determine one’s political ideology and redistributive preferences.

The last of the great classical economists, John Stuart Mill (1806-1873) devoted only a brief chapter to public debt in his *Principles of Political Economy* (1848). In Book V, Chapter VII (“Of a National Debt”), Mill does not question that a debt must be incurred
under emergencies like war, but he questions “the propriety of contracting a national
debt of a permanent character,” because funds taken from productive employment are
taken from what would have been spent on the wages of labor. On this point he concurs
with Smith, Ricardo and Say, although he focuses more on the potential detriment to
laborers than to capitalists. He is also, as they are, a pessimist on government borrowing
and a sharp critic of it. “The system of public loans, in such circumstances, may be
pronounced the very worst which, in the present state of civilization, is still included in
the catalogue of financial expedients,” although not “pernicious” if the source of lending
is abroad. Although no glut theorist, Mill nevertheless also agrees with Malthus that in
some cases public borrowing can beneficially absorb and activate otherwise idle savings,
or “the over-flowings of the general accumulation of the world,” or when capital, “after
being saved, would have been wasted in unproductive enterprises, or sent to seek
employment in foreign countries,” or when saving “has reduced profits either to the
ultimate or to the practical minimum.” In such cases, public debt may help, and
“government may annually intercept these new accumulations, without trenching on
the employment or wages of the laboring classes in the country itself,” so “to this extent,
therefore, the loan system may be carried, without being liable to the utter and
peremptory condemnation which is due to it when it overpasses this limit.”

In mentioning a “limit” to public debt, Mill echoes his predecessors in assuming
such debt cannot simply accumulate without end or any harmful result. But what is the
limit? What is the end? How is it known? Most predecessors worried or complained or warned about what they saw as excessive public debt, but failed to specify the meaning of “excessive,” or how it might be measured, what was the true “tipping point,” what it relied on, and why it was necessarily problematic. Mill’s novel contribution to the classical theory of public debt is his attempt to quantify the upper limit to public debt—
to try to answer the question of how much public debt is too much (too dangerous) and why. “What is wanted,” he argues, “is an index to determine whether, in any given series of years, as during the last great war for example [i.e. 1793–1815], the limit [of public debt] has been exceeded or not.”

Fortunately, Mill says, “such an index exists” and it is “at once a certain and an obvious one.” He asks a simple question: “Did the government, by its loan operations, augment the rate of interest?” Here is a market “index” of public debt capacity: the government bond yield. If this yield remains low (which means the government bond price remains high) and does not rise as government borrows further, no one can claim the borrowing is “excessive” or surpasses its supposed “limit.” Certainly public creditors do not believe it, for if they did, they would demand a higher interest rate, to compensate for default risk (whether explicit, by non-payment, or implicit, by inflation). “If [government] only opened a channel for capital which would not otherwise have been accumulated, or which, if accumulated, would not have been employed within the country,” Mill suggests, then its borrowing will not crowd out private borrowing or
raise interest rates, for the capital that government “took and expended, could not have found employment at the existing rate of interest. So long as the loans do no more than absorb this surplus, they prevent any tendency to a fall of the rate of interest.” In contrast, if public borrowing does raise interest rates, it is “proof that the government is a competitor for capital with the ordinary channels of productive investment, and is carrying off, not merely funds which would not, but funds which would, have found productive employment within the country.” Only when public borrowing raises interest rates is it “chargeable with all the evils which have been described.”

If valid, Mill’s market-based measurement of public debt – the open-market sovereign bond yield – may have important implications for modern theory, for even as developed nations now borrow at unprecedented levels relative to GDP, many also enjoy fast-declining borrowing rates and now pay some of the lowest yields in their history (as documented in Table 3, Chapter 2). Either today’s public debts are truly precarious, at their “limit,” and otherwise astute public creditors fail to insist upon receiving appropriately-higher yields, to offset the greater credit risk, or instead the low bond yields incorporate a correct pricing of the true credit risk, in which case public debts today are not so precarious after all – not even close to an upper limit, despite pessimists’ fears. Alternatively, perhaps over-leveraged governments today are imposing “financial repression” – techniques and schemes that mask the true (high) risk of public debt – by inducing or compelling an artificial demand for it. By repression, an
excessive supply of public debt might be matched or even exceeded by an excessive demand for it, leaving sovereign bond yields unchanged or even lower than they otherwise might be (see Chapter 6, Section 7).

Of all the better-known classical economists, only the British Ricardian, John Ramsey McCulloch (1789-1864), devotes an entire volume to public finance (McCulloch 1845). Yet his effort is largely a synthesis of the classical views of public debt, albeit leaning toward Ricardian, which is to say pessimistic, interpretations. But he incorporates sufficient contextual optimism to warrant classification as a realist on public debt. Like Ricardo, McCulloch prefers that governments eschew borrowing and pursue the all-tax approach to funding, even in emergency settings, when the tax burden may be quite high. Of special note in McCulloch, however, is his utter optimism that up to a certain point higher taxes will actual spur economic activity and foster wealth-creation, a decidedly non-classical view. In technical terms, he believes the income effect surpasses the substitution effect, even at a high tax-rate – and in this he seems more optimistic than Ricardo, who viewed all taxes as detrimental to wealth-creation.

McCulloch’s optimism, on the other hand, benefits by hindsight. Having seen the history of large public debt accumulations in Britain and the U.S., followed not by inevitable national impoverishment or bankruptcy but by decades of peace, prosperity, and debt reduction, McCulloch can be (and is) more sanguine than predecessors about the crucial surrounding context of public debt, and can better appreciate the optimistic
side of the ledger. He notes how Hume, Smith, and Ricardo mistakenly predicted near-inevitable national catastrophe due to vast public debts. Why did national financial disaster not transpire? McCulloch surmises that population, wealth, and national credit capacity each must have increased at a far faster pace than did public debts. Public debt analysis, he contends, must incorporate all those factors which permit a nation to enjoy a high credit capacity (McCulloch 1845, 423), and in this he may be characterized as a precursor to those theorists a century hence who began to relate public debt levels to GDP, and to calculate “optimal” rates of taxation and public debt. Yet even if classical economists had access to such metrics, there is little reason to suspect they would have been less pessimistic about public debt, just as access to such data today (and much more besides) does not winnow the population of contemporary debt pessimists.

Although the classical era is generally more populated with public debt pessimists (Montesquieu, Hume, Smith, Blackstone, Jefferson, Say, Ricardo, Tocqueville, and J.S. Mill), it also has influential optimists (Pinot, Mortimer, Malthus) and realists (Davenant, Melon, Steuart, Hamilton, McCulloch). It is by no means a theoretically homogenous era dominated by pessimists, as is often assumed.

Indeed, a more relaxed attitude about the dangers of public debt was already discernible in the mid-19th century, after salutary experience in the U.K with high debts. As early as the 1860s, even as the U.S. ran up large public debts and issued greenbacks during the Civil War (1861-865), some British intellectuals mocked those who had
heeded classical teachings on public debt, and thereby had become anxious about the unprecedented buildup of British public debt during the long war with France (1792-1815), predicting an inevitable national insolvency. No such thing happened, of course, which gave comfort and confidence to those who wished to condone and or even advocate high public debt levels, whether to fight wars or depression. At the turn of the century (1900) Britain and the U.S. alike could say that they had seen sky-high public debt levels, had worried about them, had feared potential financial ruin because of them, and yet had survived them without explicit default, and in subsequent decades had been able to prosper while also radically reducing their ratios of public debt to national income (Chapter 2). Among those in the 19th century who most eloquently mocked the pessimists of public debt was British historian Thomas Babington Macaulay (1864); his critique is important, as he is one of the first to insist on the need for context in assessing the causes of public debt, optimal debt capacity, and the effects of debt; one must consider public debt not in isolation but in relation to national income and assets:

Such was the origin of that [British [public] debt which has since become the greatest prodigy that ever perplexed the sagacity of statesmen and philosophers. At every stage in the growth of that debt the nation has set up the same cry of anguish and despair. At every stage in the growth of that debt it has been seriously asserted by wise men that bankruptcy and ruin were at hand. Yet still the debt went on growing; and still bankruptcy and ruin were as remote as ever. [In 1737 public debt of only £50 million] was considered, not merely by the rude multitude, not merely by foxhunting squires and coffeehouse orators, but by acute and profound thinkers, as an encumbrance which would permanently cripple the body politic. Nevertheless trade flourished, wealth increased, and the nation became richer and richer. (337) [By 1783 our debt was £240 million and] again England was given over; and again the strange patient persisted in
becoming stronger and more blooming in spite of all the diagnostics and
prognostics of state physicians. . . . [War with France raised the debt to near £800
million which] was in truth a gigantic, a fabulous debt; and we can hardly
wonder that the cry of despair should have been louder than ever. But again that
cry was found to have been as unreasonable as ever. After few years of
exhaustion, England recovered herself. . . . (339-340)

The beggared, the bankrupt, society not only proved able to meet all its
obligations, but, while meeting those obligations, grew richer and richer so fast
that the growth could almost be discerned by the eye. . . . It can hardly be
doubted that there must have been some great fallacy in the notions of those who
uttered and of those who believed that long succession of confident predictions,
so signally falsified by a long succession of indisputable facts. To point out that
fallacy is the office rather of the political economist than of the historian. Here it
is sufficient to say that the prophets of evil were under a double delusion. They
erroneously imagined that there was an exact analogy between the case of the
individual who is in debt to another individual and the case of a society which is
in debt to a part of itself; and this analogy led them to endless mistakes about the
effect of the system of funding. They were in error not less serious touching the
resources of the country. They made no allowance for the effect produced by the
incessant progress of every experimental science, and by the incessant efforts of
every man to get on in life. They saw that the debt grew; and they forgot that
other things grew as well as the debt . . . They greatly over-rated the pressure of
the burden; they greatly underrated the strength by which the burden was to be
borne. . . . (340-342)

All credit depends on two things, on the power of a debtor to pay debts, and on
his inclination to pay them. The power of a society to pay debts is proportioned
to the progress which that society has made in industry, in commerce, and in all
the arts and sciences which flourish under the benignant influence of freedom
and of equal law. The inclination of a society to pay debts is proportioned to the
degree in which that society respects the obligations of plighted faith. Of the
strength which consists in the extent of territory and in number of fighting men,
a rude despot who knows no law but his own childish fancies and headstrong
passions, or a convention of socialists which proclaim all property to be robbery,
may have more than falls to the lot of the best and wisest government. But the
strength which is derived from the confidence of capitalists such a despot, such a
convention, never can possess. That strength – and it is a strength which has
decided the event of more than one conflict – flies, by the law of nature, from
barbarism, and fraud, from tyranny and anarchy, to follow civilization and virtue, liberty and order. (342-343)

The neo-classical political economists who were predominant starting in the 1870s and lasting through World War I paid little attention to public debt theory, as public debts in that period were no longer a salient empirical issue. The world’s biggest public debtors had shown ample capacity to handle large war debts and reduce them upon peaking (in Britain after 1815 and the U.S. after 1865). Neo-classical economists focused instead on breakthroughs in marginal utility theory and advances in microeconomics; there is little if any treatment of public debt in theory or history in the works of Carl Manger, Leon Walras, William Stanley Jevons, and Alfred Marshall.

At the onset of the 20th century, public debt optimists were more prominent than they had been a century earlier, in the Smith-dominated classical era. The most extreme example of debt optimism appears in the Keynesian school, to which we turn next.
4. Keynesian Theories of Public Credit

Most contemporary political economists, whether those who endorse or else oppose a large, deficit-spending role for government, nevertheless acknowledge the theories of John Maynard Keynes (1883-1946) as the origin of the modern debate. But the case is not so strong for either side, for it was not so much Keynes but his influential academic successors, the “Keynesians,” mainly in the U.S. – notably Alvin Hansen, Abba Lerner, Seymour Harris, Paul Samuelson, Richard Musgrave, and Paul Krugman – who propounded the most logically consistent case Keynes could make for deficit spending. It turns out that the case for perpetual deficit spending and public debt accumulation comes not from Keynes but from the Keynesians.

4.1 Pre-Keynesian Context: Adams, Bastable, and Late-Classical Theory

Near the end of the 19th century, after decades of world peace, a spreading industrial revolution, and adoption of the international gold-coin standard, public debts were declining as a proportion of national income in most major nations. The classical interpretation of public debts remained dominant, and the perspective persisted that if public debts were to become too great, they would only serve to undermine constitutionally-limited government, precisely the type which had made public debt possible in the first place, starting two centuries before. This classical perspective was held even at the end of the 19th century, as illustrated by professor H. C. Adams (1851-1921), albeit a “progressive” who favored state intervention, in his 1895 textbook on
public debt. We see Adams conveying the concept that later would be called “fiscal
ilusion,” whereby public borrowing obscures the full cost and burden of government:

The most obvious, as perhaps the most serious, of the political tendencies that
accompany credit financiering, is found in the relation it bears to constitutional
government. Its workings in this regard may be very shortly and very
definitively stated. The funding system stands opposed to the full realization of
self-government. This is not at all difficult to understand. As self-government
was secured through a struggle for mastery over the public purse, so must it be
maintained through the exercise by the people of complete control over the
public expenditure. Money is the vital principle of the body politic; the public
treasury is the heart of the state; control over public supplies means control over
public affairs. Any method of procedure, therefore, by which a public servant
can veil the true meaning of his acts, or which allows the government to enter
upon any great enterprise without bringing the fact fairly to the knowledge the
public, must work against the realization of the constitutional idea. This is
exactly the state of affairs introduced by a free use of public credit.

Under ordinary circumstances, popular attention cannot be drawn to public acts,
except [as] they touch the pocket of the voters through an increase in taxes; and it
follows that a government whose expenditures are met by resort to loans may,
for a time, administer affairs independently of those who must finally settle the
account. . . . [Public debt] calls for no immediate payment from the people, but
produces vast sums for the government. It requires a certain degree of thought to
recognize that debts imply burdens, and for this reason a government that
resorts to borrowing may for a time avoid just censure. . . . The administration is
satisfied, since its necessities have been relieved without exciting the jealousy of
the people; the lenders are satisfied, since they have secured a good investment
for their capitals and are not bothered with its management; while the people are
not dissatisfied because of their profound ignorance of what has taken place.
Herein lies the danger of permitting a government freely to mortgage its
sovereign credit. (Adams 1895: 22, 24)

Here Adams appears to endorse the classically-oriented system of responsible
fiscal policies, with balanced budgets and limited issuance of public debt, yet he also
favors “the full realization of self-government,” viz., the on-going spread of democracy
and extensions of the franchise which were then beginning to occur in the progressive era, as inspired by its core aspirations, but which embodied anti-capitalist policies (Fried 2001, Fine 1969). Adams argues, astutely, that democracy, in important respects, runs counter to traditional norms of constitutionalism and classical principles of public debt. Yet he prizes open-ended, largely unlimited democracy above constitutional limitations on government powers to spend, tax, borrow and control the money supply. The progressive project to make the world safe for democracy included the goal of making government more amenable to the popular will and less-constrained by rules than it had been in the prior century. Adams suspects that as government depend more on popular support, as they do amid extensions of the franchise, they become more motivated to “veil the true meaning” and costs of their enlargement, by “fiscal illusion,” so as to lighten, even if only ostensibly, the higher burdens felt by voters-taxpayers, and that this is achievable, in part, by displacing taxes with debt. Adams senses that this can undermine a nation’s fiscal integrity, yet as a progressive, still prefers the more expansive state. This was the central conflict of public finance at the turn of the 20th century: liberty and fiscal rectitude on one hand, against an ideological desire to expand the size, scope, and cost government without also alienating the voter-taxpayer.

For Adams and the progressives, the “free use of public credit” necessarily “must work against the realization of the constitutional idea,” and to the extent an enlarged, progressive state requires a liberal use of public credit, legal limits on that state must
yield. People will not become dissatisfied with the higher cost of government because of
their general ignorance and indifference about what actually occurs in politics and its
complex bureaucracy. Adams labels the state’s unlimited power to borrow a “danger,”
but like most progressives, sees public debt as an ideal means of reconciling the conflict
between having a costly government and, as well, a popularly-supported government.

In fact, the same progressive movement of which Adams was a part, in the realm
of public finance, itself instigated an erosion in public fiscal responsibility over the
subsequent century, by its insistence that political elites by-pass or jettison constitutional
limits and laissez-faire policies in favor of vast new powers to regulate, spend, tax,
borrow, and underwrite public debt through money issuance by newly-established
central banks. This shift in ideology coincided with the return of mercantilist-oriented
economists who welcomed a larger role for the state, who believed free markets were
prone to bouts of “over-production,” excessive saving, slumps, and mass joblessness,
and who were convinced that if governments were free to engage in unlimited deficit
spending and public debt issuance, market failures could be fixed and prosperity
perpetuated. In time this new view of the state’s economic role was dubbed the “new
economics” by its main adherents in the mid-20th century, but in truth it revived the old
economics of pre-Smithian mercantilism and the “general glut” fears of Robert Malthus.

The public debt norms extant at the start of the 20th century, which progressives
would soon supplant, were captured succinctly in widely-used textbook on public
finance (Bastable 1903, 611): “Under normal conditions, there ought to be a balance between these two sides [expenditure and revenue] of financial activity. Outlay should not exceed income, ... tax revenue ought to be kept up to the amount required to defray expenses.” “This general principle must, however, admit of modifications. Temporary deficits and surpluses cannot be avoided. . . . All that can be claimed is a substantial approach to a balance in the two sides of the account. The safest rule for practice is that which lays down the expediency of estimating for a moderate surplus, by which the possibility of a deficit will be reduced to a minimum.”

With certain exceptions the classical economists had viewed deficit spending as improper and detrimental to savings, capital formation, and long-term prosperity, but for progressives and Keynesians alike, we shall see, such dangers held only in the context of full employment. Unemployment, Keynes argued, reflected excessive saving and insufficient private investment, but could be cured by government dis-saving (deficit-spending) and investment. In the U.S. during the 1930s unused industrial capacity averaged 30%, the jobless rate averaged 18%, firms and households hoarded cash, and banks sat atop vast excess reserves. Keynes argued that if these hoarded funds could put to work by an extensive “socialization of investment,” idle labor likewise could be put to work. Unemployment should not be reduced by tax cuts, because some after-tax income is saved, and the problem was already excessive saving; nor should government spending be financed by tax increases, as that would reduce consumer
spending and business investment, which were already deficient. Although Keynes saw
deficit spending as one cure for depression, he denied it was warranted otherwise.
Public debt should be incurred mainly to match government capital investment, not
ordinary current spending or transfers. Keynes was wary of consumptive and perpetual
public borrowing; in this regard alone he might be classified not as a public debt
optimist, but as a realist who recognizes the importance of context and qualification.

Nevertheless, instead of viewing unemployed labor as an exception to the rule in
a free economy, as had the classical economists (who said it was best cured by lower
wage rates), Keynes argued that unemployment was the normal case. He characterized
his offering as a “general theory,” in contrast to classical economists’ mere special case,
named the malady “involuntary unemployment,” and advised governments to deficit-
spend in order to supplement private spending (consumer spending plus business
investment). More spending would absorb idle savings, boost investment, raise the
demand for labor, and reduce the jobless rate. The Keynesians who elaborated on
Keynes’s argument and pushed it to its logical conclusion in the 1950s and 1960s argued
that the “paradox of thrift” was a permanent risk to the economy, which would suffer
“secular stagnation” in the absence of compensatory finance. If underemployment was
now the rule (albeit less severe than in the 1930s), not the exception, deficit-spending
also should become the norm in fiscal policy, not the exception. Public deficits and debts
may become chronic, yet not unwelcomed, for they could cure unemployment in markets that rarely cleared.

According to Buchanan and Wagner (1977), Keynes in the 1920s and 1930s almost single-handedly overturned the “old time fiscal religion” of the Victorian era, with its norm of balanced budgets over the long term, and post-war Keynesian successors could not have been so influential without Keynes’s base.

Without Keynes, government budgets would have become unbalanced, as they did before Keynes, during periods of depression and war. . . . But these events of history would have been conceived and described differently, then and now, without the towering Keynesian presence. Without Keynes, the proclivities of ordinary politicians would have been held in check more adequately in the 1960s and 1970s. Without Keynes, modern budgets would not be quite so bloated, with the threat of more to come, and inflation would not be the clear and present danger to the free society that it has surely now become. The legacy or heritage of Lord Keynes is the putative intellectual legitimacy provided to the natural and predictable political biases toward deficit spending, inflation, and the growth of government. (25-26)

For Buchanan and Wagner (1977), by the 1970s “few could quarrel with the simple thesis that the effective fiscal constitution in the United States was transformed by Keynesian economics. The old-time fiscal religion is no more.” (23) In 1977, U.S. public debt was $707 billion, or just 35% of GDP, and a mere 11% of annual U.S. federal spending over the prior decade (1968-1977) had been borrowed; by 2012, in the wake of a revival of Keynesian deficit-spending, purportedly to mitigate the “Great Recession” of 2007-2009, the U.S. public debt totaled $16 trillion, or 105% of GDP, and during the prior decade 22% of annual U.S. federal spending had been borrowed. Thus U.S. federal
debt tripled as a share of GDP from 1977 (35%) to 2012 (105%) while the borrowed portion of federal spending doubled (measured for the prior decade), from 11% to 22%. To some, the fears of excessive public debt expressed in 1977 seemed validated in 2012, except that the 10-year U.S. yield fell to 1.5%, compared to an average of 7.5% in 1977; bond investors today seem fearless about the U.S. fiscal trend that so scares pessimists.

Most debt theorists believe acceptance of Keynes’s theory of deficit-spending and its power to sustain or stimulate an economy, without causing financial ruin, was greater after World War II than previously. U.S. deficit spending was unprecedented during the 1930s, not only because it was a peacetime decade, but because the spending seemed powerless to exert a positive economic effect. Compared to the “Roaring Twenties,” in which U.S. budget surpluses were applied to a one-third reduction in the national debt, the 1930s saw the U.S. borrow 39% of total federal spending and more than double the federal debt, from $17 billion (16% of GDP) to $40 billion (44% of GDP). In the 1920s the U.S. jobless rate had averaged less than 5% while industrial output increased by 36%, but in the 1930s the jobless rate averaged 18% (and 17% in 1939), while industrial output increased by only 24%. In contrast, deficit spending during WWII and the 1940s coincided with a boom in GDP and a material drop in the jobless rate; Keynes died in 1946, but his acolytes credited his theories with the 1940s boom.

Yet while post-WWI debt theory and policy became more intensive and extensive, in form, than what Keynes advocated, even before Keynes became prominent
in the 1920s and 1930s there was growing evidence of a relaxation of the balanced budget orthodoxy. Buchanan (1986) describes what he sees as the change in attitude:

We have passed through several shifts in ideas and attitudes. Even before Keynes, economists had challenged the classical (and Victorian) equivalence of public and private debt. Fallacies of aggregation antedate Keynesians, and the argument that “we owe it to ourselves” was ushered in early in the century. This aggregation fallacy, to the extent that it gained acceptance, served to loosen somewhat the precepts of fiscal prudence for governments, although the principle of budget balance kept public debt creation within bounds of reason.

Norms of private capital accumulation and preservation remained pervasive, however, until Keynes and the Keynesians promulgated the “paradox of thrift.” With this step, even the norms of for private, personal prudence came to be undermined. Spending, not saving, spilled over to benefit society. Alongside this inversion of private norms, the Keynesian theory of public policy directly undermined any intellectual basis for the maintenance of balance in governmental budgets. The modern era of profligacy, public and private, was born. Through their effects on public and political attitudes, ideas do have consequences. But these consequences emerge only with significant time lags.

After Keynes, the anti-classical, anti-Victorian ideas were firmly in place among academics and in the dialogues of the intellectuals. Politics, however, reflects the behavior of politicians, whose ideas change but slowly. Hence, during the years after World War II, many politicians adhered to the old fashioned precepts of fiscal prudence, only to be treated condescendingly and with scorn by academics and intellectuals. . . . The politicians who made the policy decisions of the 1950s and 1960s had fully absorbed the Keynesian lessons on both macroeconomic policy and public debt . . . because [these lessons] offered apparent intellectual support for their natural proclivities to spend and not to tax. The era of seemingly permanent and increasing government deficits was upon us, and era from which we have not yet escaped. (366-367)

The optimistic Keynesian view of public debt did not spring out of an intellectual vacuum, as Buchanan acknowledges. A cultural ethic – which Buchanan names “Victorian” – slowly eroded, and as it did, there arose important precursors to Keynes.
4.2 World War I, the Resumption of Large Public Debts, and the Need for New Theory: A.C. Pigou

Not until World War I (1914-1918) and its aftermath does one find political economists once again debating whether to be pessimistic, optimistic, or realistic about public credit and debt – and for obvious reasons, since public debt again became an eye-popping empirical phenomenon. Britain’s ratio of Debt/GDP had declined steadily from an all-time high of 261% in 1821 (a few years after the end of the Napoleonic wars), to just 25% at the outbreak of World War I in 1914; by the end of World War I its debt ratio was 115%, but then climbed further, to a peak of 182% in 1923, before declining in the 1930s, to 110% (1940); thereafter it increased again, during World War II, to a peak of 238% (in 1947). Likewise, the U.S. Debt/GDP ratio had declined steadily over the five decades before World War I, from a peak of 33% (in 1869) to just 3% at the precipice of World War I (1914). By the end of that war the U.S. debt ratio was again 33%, and then halved to 16% by 1929, before doubling again to over 35% in the 1930s amid the Great Depression; the debt ratio was 39% on the eve of World War II and by war’s end had peaked at 121% (1946), at which time it was roughly half the level of Britain’s ratio.

The public debt analysis of British political economist and Cambridge professor A.C. Pigou (1877-1959) is important, not only because he was an originator of welfare economics, but because Keynes used Pigou as a foil, or convenient stand-in, for the classical economic position on key issues of theory and policy (including deficit-spending). In truth, Pigou’s views would have been rejected by most classical
economists, since he allowed for (and advocated) far greater government intervention in
the economy than did they. Pigou is an important transition figure between the neo-
classical economists that first arose in the 1870s, and the rise of Keynes in the 1930s.

The first edition of Pigou’s *Study in Public Finance* (1928) appeared in the inter-
war period, but before the onset of the Great Depression. He devotes most of the book to
taxes, but a third of it to debt. Pigou argues that regular current expenditures by
government ought to be financed out of taxes, with no perpetual deficit spending, but
that extraordinary spending, mostly due to war, should be partly borrowed. In
peacetime, the debt should be reduced as much as possible. Thus in the 1920s, before the
appearance of Keynes’s *General Theory* (1936), we find Pigou agreeing with the classical
economists that public finance policy should foster the long-term prerequisites of
national wealth-creation, that private saving and investment are crucial to capital
accumulation, productivity gains and prosperity, and that excessive government
borrowing only saps savings and undermines long-run prosperity, as does public
borrowing for non-productive purposes beyond war outlays (transfers). But by the time
the third (and final) edition appears of Pigou’s *Study in Public Finance* (1956), there is a
more Keynesian assessment of the propriety of deficit spending and public debts; now
Pigou acknowledges, as he did not in 1928, a deficit-spending role for government, as a
way of mitigating “involuntary unemployment.”
In his first edition of the *Study in Public Finance* (1928), Pigou contends that “in a well-ordered state, [regular] expenditure will be provided for out of taxation, not by borrowing,” for “to meet [ordinary spending] by borrowing, whether from foreign or domestic lenders, would involve an ever-growing debt and a corresponding ever-growing obligation of interest” such that “the national credit would suffer heavy damage, and ultimately the annual obligations of the government might come to exceed the maximum sum that it had the power to raise in tax revenue.” The consensus in the 1920s is clear and obvious, to Pigou, as he declares that “this thesis is universally accepted,” since “nobody would suggest that government expenditure of a regular nature, such as expenditure on the army, navy, and civil service [in peacetime], should normally be met otherwise than out of taxation.” (231) In the usual case, public loans should be used only for tax smoothing, to preclude unnecessary and disruptive gyrations in tax rates, especially pro-cyclical tax hikes that seek to balance budgets in recessions. But Pigou also endorses public borrowing to finance public spending that is “devoted to producing capital equipment,” including utilities and infrastructure; as with productive loans in the private sector, those in the public sector can yield revenues and incomes that can assist in debt service; the same cannot be said of consumptive loans, or borrowing to fund income transfers. Here Pigou mirrors the classical position.

Even when public loans are incurred legitimately, that is, under extraordinary circumstances (war), Pigou argues that they “ought, in general, to be financed in such a
way that the loans are paid off out of taxes before the need for further similar expenditures is likely to occur. For if this is not done, there must result an ever-growing debt and, eventually, the need for ever-growing taxes.” (233) Pigou opposes the perpetual accumulation of public debt. As for taxable capacity, in 1928 Britain’s government spent 29% of GDP, down from 57% at the end of World War I (1918), and for most of the 1920s it generated annual budget surpluses, so Pigou was aware that Britain’s taxable capacity in 1928 was at least twice that of a decade earlier. Indeed, by the end of World War II (in 1945), when Britain’s spending peaked at 70% of GDP, its total public debt peaked at 238% (in 1947), yet the price of its 2.5% consol increased during the war, as its yield dropped from an average of 3.35% (1940) to 2.85% (1947).

Pigou is aware that the popular thing for a politicians to do is spend and borrow, while minimizing (or reducing) taxes, but, he warns, “to allow governments anxious for popularity to base their financial arrangements upon speculations of this kind is not a little dangerous.” (233) Fiscal prudence, he says, also requires a sinking fund, the standard, classical device for sequestering funds for future principal amortization.

As to the burden or incidence of public debt, Pigou acknowledges but does not endorse what he calls the “common belief that when an enterprise is financed out of taxes the cost of it is borne by present tax-payers, but that when it is financed out of loans, the present generation, since the lenders get value for their loans, bears no real costs, the whole of this being borne in future years.” (234) If debt is due to war, perhaps
posterity should willingly bear the future burden of the public debt, because it also enjoys the benefit associated with its incurrence, in that “posterity has been protected from enslavement.” (234) In fact, Pigou denies that the burden of public debt weighs upon posterity; it mainly weighs on the current generation that incurs it, he contends, in the course of endorsing the view, which we first found in Melon (1737) that “we owe it to ourselves,” as least regarding domestically-held debt. Future British citizens are burdened only if they owe foreigners, not if they owe each other (domestic-held debt).

“When [interest] is taken from the income of taxpayers in taxes” it “goes into the income of holders of loan stock,” and “all that happens is a transfer of income from one section of the community to another section, and, in so far as taxpayers and loan holders are identical, from one pocket to another pocket in the same coat. Plainly, in a transfer of this kind, it is impossible that any direct objective burden . . . can be involved.”(235)

What of bond principal, which by contract is to be repaid far into the future? Who bears its burden, and is it matched by any corresponding benefit? If the ultimate repayment is provided by installments, as by an annual tax to fill a sinking fund (as Pigou prefers), the debt is not a burden to some single, future generation, but is so to all those taxed partly and incrementally along the way to the bond’s maturity. Viewed empirically, “the British nation,” Pigou maintains, “owes the predominant part of [the national debt] to itself,” and to that extent is not burdened by it; only to the extent it owes foreigners is its position “analogous to that of an individual debtor,” but insofar as
the British government owes a debt to its citizens, incurring the debt entails no net burden; likewise, any repayment of such debt “involves no drain on the resources of the community as a whole, because, though no part of the community transfers resources to another part, the community as a whole pays nothing.” (288-289) This is confirmed, he says, by imagining the immediate retirement of the public debt, in whole or in part, by a one-time capital levy (tax) on the rich, as Ricardo once advised. A decade earlier, in fact, Pigou (1918) had recommended a levy to retire the British debt incurred in World War I. Less debt would allow more saving and investment, and deprive idle bondholders; a levy was problematic, for Pigou, only if it curbed investment or prompted capital flight.

If, as Pigou prefers, the proceeds of public borrowing in normal times is restricted to investment in public capital yielding an income, a benefit attaches to (and offsets) the burden; a future generation receives both a liability (debt) and asset (road), not a negative estate. “Posterity will possess the new capital which it has been induced by the fiscal expenditures of the state to create,” so “no cosmical catastrophe is in sight,” for “posterity may be expected to reap the fruits of its investments in the same way as its ancestors.” In sum, “the bondholder gets no benefit from repayment [of public debt],” “while it is also true that the taxpayer suffers no loss.” (236) “The payment of interest and the repayment of principal alike are transfers, not costs, and to whatever is somewhere lost, there corresponds elsewhere an exactly equivalent gain.” (236-237) Given his contextual and balanced analysis, Pigou may be classified as a debt realist.
Writing in 1928, Pigou had not yet faced the prospect of a Great Depression (1930s), and with it a decline in tax revenues so large as to cause a magnitude of deficit spending heretofore associated only with war. Would this be characterized as an extraordinary circumstance like war, and thus not require extra taxation to narrow the budget gap? Would deliberate deficit spending in a depression be a valid fiscal policy, and more, be crucial to an eventual economic recovery? In 1928 Pigou purports to offer “a strict rule,” but in fact concludes ambiguously: “Prudence seems accordingly to suggest that borrowing should hardly ever be adopted except for strictly economic expenditure, and then only when the extension of the state domain is clearly advisable. This strict rule points, I think, to the right path in all ordinary circumstances.” (248) By “economic expenditure” Pigou does not imply a counterpart to war expenditure, nor does he mean to endorse deficit spending so as to stimulate a depressed economy, but rather public spending for investment purposes that yields future revenue and income sufficient to service the debt incurred. In 1928 it remains unclear, in Pigou, whether a Great Depression of the kind soon to be observed, justified a “clearly advisable extension of the state domain,” due to conditions that were unprecedented, quite the opposite of “ordinary circumstances.” The truly “strict rule” of balancing budgets under all “ordinary” circumstances, defined generally as any peacetime setting, caused the U.S. federal government in 1932 to raise top income tax rates from 25% to 62%, to close a budget gap, but in consequence turned a recession into a depression. In the third and
last edition of *A Study in Public Finance* (1956), published two decades after the Great Depression and Keynes’s *General Theory* (1936), Pigou devotes the section on public debt largely to its potential as a depression fighter and job creator – that is, in a more Keynesian sense. Subdued is his earlier pre-occupation with orthodox, classical prescriptions for public debt issuance, management, and incidence; now taking precedence is a discussion of whether and to what extent economic downturns and mass unemployment may be deemed so unprecedented as to warrant equally-unprecedented peacetime deficit-spending and a temporary suspension, if not a complete overthrow, of the old-school, balanced-budget orthodoxy.

On public debt, Pigou restates some of the old orthodoxy, from the pre-depression edition of 1928, that in “normal times” the budget ought to be balanced or, indeed, in surplus, permitting war-time debt to be reduced. To borrow publicly in such times is dangerous because debt buildups become perpetual, and eventually strain a nation’s productive prowess and taxable capacity. But in the 1956 edition Pigou adds new sections and a key new condition that was no part of his 1928 book, and now stresses that “in some circumstances a case may be made out for using budget deficits in bad times offset by surpluses in good times as a means of steadying and improving employment.” (36) By “bad times” Pigou means bad economic conditions – recessions, depressions – and contends that deficit-spending can help reduce joblessness. The Pigou who previously had been cast by Keynes, in his *General Theory* (1936), as the
representative classical economist, by 1956 appears as an overt Keynesian, at least as it pertains to advocacy of the counter-cyclical potentialities of expansive deficit-spending.

For the dwindling contingent of old-time classical economists surviving the 1950s, it was one thing to have observed young Keynesian economists eagerly, perhaps naively, adhering to Keynes’s theories, but it was quite another to witness Pigou, one of their own, following Keynes nearly as eagerly, at least on public debt theory. In the final edition of his *Study in Public Finance* (1956) Pigou devotes entire new chapters to the job-creating possibilities of accumulating public debt, especially when wage rates do not seem capable of declining sufficiently to equilibrate supply and demand in the labor market. Like the Keynesians, Pigou in 1956 ridicules “the Treasury View,” whereby the British Exchequer, adhering to old orthodoxy, long-denied that deficit-spending, public-works projects, or money-printing could cure depressions or mass unemployment; instead and at best such schemes only redistribute jobs and wealth, not multiply them. For Pigou in 1956, the issue is “less simple than it seems to be at first sight.”(232), perhaps including his own first sight in 1928. “When private industrialists think that prospects are black,” he writes, “they so act as to promote a decrease in aggregate money incomes,” and in such cases, he now insists, “the public authorities” “must be able to influence the aggregate money income” (232), if necessary by massive deficit-spending. Even loss-making public projects are defensible, says Pigou, as there should
be “nothing to prevent” government “from undertaking, in the interests of employment, investment whose yield is expected to be nil or even negative.” (233)

Pigou’s shift between 1928 and 1956 is remarkable. The old orthodoxy had said government should borrow mainly for war; borrowing in peacetime was defensible only for productive reasons, as with prosperity-enabling infrastructure. The new, Keynesian orthodoxy instead counseled loss-creating deficit-finance if it could create jobs amid mass (or even moderate, yet structural) unemployment. The key justification for “investments by public authorities financed by loans” is not their net financial benefit or profitability, Pigou now argues (1956), but their power to foster “increases in aggregate money outlay,” and in this regard he now seems perfectly satisfied to use “the language which is now fashionable among some [Keynesian] economists,” even to declare that “not only is the relevant multiplier positive, but it is greater than unity.” (236-237)

Of special relevance in the 1956 edition of Pigou’s Study in Public Finance is his post-Keynesian defense of perpetual deficit-spending, not only in peacetime, and not only for loss-making infrastructure projects, but to better redistribute income and wealth from the rich, who save relatively more of their income, to the middle class and poor, who save relatively less of their incomes and thereby spend relatively more of them on consumer goods. By such means, Pigou contends, in line with Keynesian theory, there necessarily results greater aggregate national income and less unemployment. “The bulk of this money is pretty sure to be expended on the purchase of consumption goods, and
so indirectly in creating money income for producers of those goods,” he contends, and though “some of the borrowed money may have come out of what would been private investment,” nevertheless “the primary effect of this public finance operation” will be “a larger proportion of aggregate purchasing power coming to be held by relatively poor persons” and thus “an increase in aggregate money outlay.” (237) In 1956 Pigou also insists that public debt must not be viewed as a burden to future generations:

> It is sometimes thought that whether and how far an enterprise or enterprises ought to be financed out of loans depends on whether and how far future generations will benefit from it. This conception rests on the idea that the cost of anything paid for out of loans falls on future generations while costs met out of taxes are borne by the present generation. Though twenty-five years ago this idea could claim some respectable support, it is now everywhere acknowledged to be fallacious. It is true that loans raised from foreigners entail a burden represented in interest and sinking fund on future generations in the borrowing country. But interest and sinking fund on internal loans are merely transfers from one set of people in the country to another set, so that the two sets together – future generations as a whole - are not burdened at all. . . [Whether by taxes or debt] it is the present generation that pays. (Pigou 1956, 37-38)

> The organistic-nationalistic aspects of this inconsistent argument are worth noticing. Society is conceived as an organism, a collective existing eternally, in the present and future, in which the individual (or sets of them, whether as debtors and creditors, or entire generations) is a mere dispensable part, and the entire organism may have debts, but these are owed to itself, and thus entail no net burden to itself; yet the world is not similarly-conceived, and international (external) public debts somehow do not cross-cancel; a nationalist premise is then introduced, to draw an arbitrary line at
borders, such that real debt burdens exists after all, at least between nations (and for some, between generations). Valid theories cannot survive such arbitrary line-drawing.

Obviously, an important change occurs, over the first half of the 20th century, in theorizing by major political economists about public debt, a change which, whether classified as evolutionary or revolutionary, nonetheless undermines the old balance-budget orthodoxy that was so widespread in the late 19th century. The change is not truly revolutionary, to the extent more optimistic theories of public debt had always existed, and were occasionally rehabilitated when it became expedient for advocates to do so. Consider only the pamphlet by Wilkeson (1865), which unabashedly peddled U.S. debt through Jay Cooke & Co., financier of the union side of the Civil War, with the opening lines that “the five great powers of the world [Great Britain, the U.S., France, Austria, and Russia] have each a permanent national debt” and such debt was not, despite what pessimists had claimed, “a penal necessity,” because the capacity of America (and other powers) to service public debt “has been demonstrated by an exhibit of the resources of the nation.”

By the end of the 19th century attitudes toward public debt existed on a continuum, and it was only a matter of the degree of emphasis among pessimists, realists and optimists. Throughout that century the Hamiltonian realists, who saw public debt as beneficial in certain cases but harmful in others (if “excessive”), were in the minority, out-numbered the most by the pessimists, who viewed public debt as
almost always harmful (and worthy of full retirement if it existed at all), and out-numbered also, but to a lesser extent, by the optimists, who insisted public debt was usually beneficial (and could safely be permanent). The 19th century was dominated by public debt pessimists, reflecting the trailing influence of classical political economy; but the first half of the 20th century saw the spreading influence of debt optimists, due to the coincident rise in progressive-ear politics, which advocated a more expansive economic role for government, by more regulation, trust-busting, taxation, spending, borrowing, or monopolistic money issuance. By 1913 all such policies had been adopted in the U.S.

4.3 The Depression-era Boom in Public Debt and Revival of Mercantilist Premises: J.M Keynes

Despite Keynes’s reputation as an advocate of aggressive deficit-spending, his writings, in fact, are relatively sparse on the topic, and even the substance of his message about public deficits and debts alike is more mixed than is usually acknowledged. According to Clarke (1997, 69-70), those who peruse the entirety of Keynes’s work find in it few references to budget deficits, deficit-spending or public debt. Of the thirty volumes comprising Keynes’s Collected Writings, the last, a 373-page index to all topics covered in the prior volumes, contains a total of 746 columns, yet only one-tenth of one column has references to deficits or debt (or to deficit-spending, a policy Keynes calls “loan expenditures”). Keynes wrote far less on the topic of public deficits and debts than is commonly believed, and as we will see, his scant views on the topic occasionally
reflect classical precepts, especially those which insist that peace-time deficit spending, if it occurs at all, should fund productive public investments instead of transfers.

Keynes’s first foray into the issue of sovereign debt occurred not in the 1930s, when the world was suffering from a deep economic depression, but in the aftermath of World War I, when the victorious Allied Powers (U.S., Britain, France) were seeking to impose roughly $40 billion in reparations on the defeated Central Powers (mainly Germany), at the Paris Peace Conference in 1919. Keynes, then a junior member of the contingent representing Britain at the conference, became famous after quitting the proceedings and soon thereafter publishing *The Economic Consequences of the Peace* (1920). In it he mocks the Allied leaders for demanding reparations in the first place, but especially in a magnitude that, by his estimates, would undermine, bankrupt and starve Germany and large portions of European. “The existence of the great war debts is a menace to financial stability everywhere” (279), he writes, and to political stability also, for they could stoke resentment and disruptive revolutions harmful even to victors. Although here Keynes does not examine public debt in the form of publicly-traded securities, nevertheless he analyzes a nation’s capacity to meet international obligations, and he concurs with classical economists that these are more burdensome than domestic obligations. Keynes examines Germany’s post-war debt-paying capacity by reference to the potential revival of its war-torn economy, to the reliability of its future tax base, and to the likely flow of net exports required to secure the incoming cash flow needed to

175
meet reparations. But in so doing, he concludes that “Germany’s capacity to pay will be exhausted by the direct and legitimate claims which the allies hold against her.” (120) Keynes also makes an argument in favor of inter-generational equity; like Thomas Jefferson he denies that future generations should be made to shoulder undue burdens forwarded by prior ones. “Nations are not authorized, by religion or natural morals,” Keynes writes, “to visit on the children of their enemies the misdoings of parents and rulers,”(225) – including any reparations resulting from such misdoings.

According to Keynes, Germany probably could afford to pay only $10 billion (200) in reparations over a generation, or just quarter of the $40 billion (Keynes 1920, 161) which had been demanded of it (albeit ambiguously) in the Treaty of Versailles. The remainder, Keynes says – $30 billion or so, payable mostly to the U.S. and Britain – should be cancelled (270), forgiven (by U.S. “generosity”) or, if necessary, repudiated – even though he concedes the loans were indispensable to defeating Germany. Soon after the Versailles Treaty was signed, German’s required reparations were reduced, by 16% in 1921 (to the equivalent of $20 billion at the time), yet it still defaulted in 1923, and a year later its reparations were restructured and reduced again, under the Dawes Plan (1924). Five years later Germany’s reparations obligations were reduced again, by 50%, under the Young Plan (1929), to the then-equivalent of $8 billion, payable over sixty years. Hitler repudiated all remaining sums upon gaining power in the 1930s.
Given the abandonment of the classical gold standard during World War I, public debt theory in the 20th century had to deal with the interaction of changes in monetary values and debt burdens. Devoid of an objective anchor, money could be more easily manipulated under systems of inflationary finance. In the early 1920s German finance officials, echoing Keynes’s critique of the Versailles Treaty, decried what they saw as insuperable reparations, and hyper-inflated the mark. In *The Economic Consequences of the Peace* (1920) Keynes had noted how “the inflationism of the currency systems of Europe has proceeded to extraordinary lengths,” and how “the various belligerent governments, unable, or too timid or too short-sighted to secure from loans or taxes the resources they required, have printed notes for the balance.” (238) The German hyperinflation of 1921-1924 was an extreme form of inflationary debt repudiation, but Keynes viewed the policy, in principle at least, as an ingenious, nearly-untraceable expedient that no rational government should exclude from its policy arsenal. He was well aware of the surreptitious manner by which an unanticipated inflation could redistribute income and wealth from creditors to debtors – that is, how the latter are better able to repay the former by paying in less-valuable money – which is but another way of acknowledging that inflation is an opportunistic means by which a government can lighten its public debt burdens, especially if it exerts a near-monopolistic control over the issuance of money. In *The Economic Consequences of the Peace* (1920) Keynes writes of how,
By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and while the process impoverishes many, it actually enriches some. The sight of this arbitrary re-arrangement of riches strikes not only at security, but at confidence in the equity of the existing distribution of wealth. Those to whom the system brings windfalls, beyond their deserts and even beyond their expectations or desires, become “profiteers,” who are the object of the hatred of the bourgeoisie, whom the inflationism has impoverished, not less than of the proletariat. As the inflation proceeds and the real value of the currency fluctuates wildly from month to month, all permanent relations between debtors and creditors, which form the ultimate foundation of capitalism, become so utterly disordered as to be almost meaningless; and the process of wealth-getting degenerates into a gamble and a lottery. . . . There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose. (235-236)

We see that Keynes is well aware that inflation tends to disorder debt relations, specifically to benefit debtors at the expense of creditors, yet condones (and at times actively endorses) the policy anyway; he is not merely opposed to deflation, which helps creditors at the expense of debtors. He also notes, in The Economic Consequences of the Peace (1920), that culpability for rising prices can be easily shifted and assigned, in the popular mind, to the price-setter (business) instead of the money-issuer (government). Since “not one man in a million” can diagnose the cause or cure for inflation, “popular indignation” toward rising prices, the result of “vicious methods” of public finance, can be deflected to “profiteers,” to the “entrepreneur class of capitalist,” to what is, in truth, “the constructive element of the whole capitalist society,” (236) but one which can serve as a scapegoat for the fiscal misdeeds of political elites. “By directing hatred against this
[capitalist] class," Keynes writes, the “fatal process” of debasing the currency can be intensified and extended. “By combining a popular hatred of the class of entrepreneurs with the blow already given to social security by the violent and arbitrary disturbance of contract” caused by inflation, governments necessarily make “impossible a continuance of the social and economic order of the 19th century.”(237) Keynes calls inflation a “fraud upon the public,” but a fraud which recipients of depreciating currency discover only when “the worthlessness of the money becomes apparent.”(240) Again, it seems significant that Keynes is not much opposed to inflation, even while knowing it’s harms.

Aware of the policy implications of popular hatred for capitalists and entrepreneurs, Keynes seems aware also of popular distrust of creditors and lenders, and suggests that public finance policy might exploit the sentiment. “A debtor nation does not love its creditor,” he writes (278), adding that debtors are effectively enslaved by oppressive creditors whenever debts are excessive and beyond the capacity of the debtor to pay. In such circumstances debtors will “make constant attempts to evade or escape payment,” which in turn becomes a source of “friction” and “ill-will.”(278) Large, inter-sovereign debts are particularly onerous, Keynes says, and he seems to oppose them entirely; when one sovereign owes another sovereign, sovereignty itself becomes, perhaps, a sham. On this view “the continuance on a huge scale of indebtedness between governments has special dangers,” for they are, according to Keynes, “vast paper entanglements” which cause the international financial system to be “in the
highest degree artificial, misleading, and vexatious.” Keynes contends that the world economy “shall never be able to move again unless we can free our limbs from these paper shackles.” Indeed, at the close of World War I he counsels a massive, one-time cancellation of inter-government debts and obligations. “A general bonfire [of debt paper] is so great a necessity that unless we can make of it an orderly and good-tempered affair,” it will “grow into a conflagration that may destroy much else as well.” As for internal public debt, Keynes declares that “I am one of those who believe that a capital levy for the extinction of debt is an absolute prerequisite of sound finance.”(280) Thus he endorses the same confiscatory tactic vetted by the likes of Ricardo and Pigou.

In *The Economic Consequences of the Peace* (1920) Keynes seems more like a debt pessimist, which runs counter to his stereotype as an optimist who stresses debt’s power to stimulate economic activity; he also clearly throws his intellectual weight behind public debtors, and aims his more heated rhetoric at public (and private) creditors; finally, he seems not averse to seeing over-indebted governments surreptitiously inflating away their excessive debt burdens, or imposing special one-time taxes on a nation’s rich class, to retire debts – all in the name, he insists, of “sound finance.” In his *Tract on Monetary Reform* (1923), Keynes, eying Germany’s recent experience with hyper-inflating the mark (1920-1923), reiterates his view that inflation is a powerful means of financing an over-indebted state, especially one that seeks to repudiate its obligations:

A government can live for a long time, even the German government or the Russian government, by printing paper money. That is to say, it can by this
means secure the command over real resources – resources just as real as those obtained by taxation. The method is condemned, but its efficacy, up to a point, must be admitted. A government can live by this means when it can live by no other. It is the form of taxation which the public find hardest to evade and even the weakest government can enforce, when it can enforce nothing else. . . . The burden of the tax is well spread, cannot be evaded, costs nothing to collect, and falls, in a rough sort of way, in proportion to the wealth of the victim. No wonder its superficial advantages have attracted Ministers of Finance. . . . Like other forms of taxation, these exactions, if overdone and out of proportion to the wealth of the community, must diminish its prosperity and lower its standards . . . But this effect cannot interfere very much with the efficacy of taxing by inflation . . . [T]he government can still secure for itself a large share of the surplus of the community. (41-43)

Keynes is aware not only that currency depreciation, leading to price inflation, can serve as a hidden tax on cash balances, but also can diminish the real value of public debt owed, because creditors receive interest and an ultimate return of principal in money of lesser value. In the Tract on Monetary Reform (1923) Keynes explains how inflation can surreptitiously reduce the real public debt burden:

We have seen in the preceding section the extent to which a government can make use of currency inflation for the purpose of securing income to meet outgoings. But there is a second way in which inflation helps a government to make both ends meet, namely by reducing the burden of its preexisting liabilities in so far as they have been fixed in terms of money. These liabilities consist, in the main, of the internal debt. Every step of depreciation obviously means a reduction in the real claims of the rentes-holders against their government. It would be too cynical to suppose that, in order to secure the advantages discussed in this section, governments (except, possibly, the Russian government) depreciate their currencies on purpose. As a rule they are, or consider themselves to be, driven to it by necessities.(63)
Here we see Keynes’s idealistic conception of government policy intentions; he believes “cynicism,” not realism, leads observers to suspect that governments might resort to inflation whenever they find it expedient to avoid the resentment of taxpayers (towards higher taxes) or bondholders (towards explicit default). In truth, as Keynes knows, the history of currency debasement reveals mostly deliberate intent by cash-strapped sovereigns hoping to retain popularity, which secure funds deceptively, like an embezzlement. Indeed, he says “the most cogent reason” a sovereign has for a “permanent depreciation” (devaluation) of the currency is to instantly reduce its debt burden; in reducing the real value of its currency, the sovereign reduces his non-interest-bearing obligations, for under a gold standard, the system of the 1920s, a currency is a pledge to pay a fixed weight of gold, if demanded, and as the sovereign’s interest-bearing obligations (bonds) are denominated in such currency, its devaluation also devalues that which is owed to public bondholders. A resort to currency depreciation, in order to slash the real value of public debt, is not, for Keynes, a breach of trust or a violation of the sanctity of contract; it only means “moderating the claims of the rentier” (bondholder), whenever the state decides that its debts have reached “an insupportable level,” or “an excessive portion of the national income.”(64)

Indeed, as we shall see, in his more famous book, the General Theory (1936), Keynes endorses a deliberate public policy of radically depressing the interest rate received by public bondholders, to the point of achieving, in his own words
(presumably metaphorical), “the euthanasia of the rentier class.” On such occasions we find Keynes harboring what seem to be medieval-type prejudices about lenders as slothful, greedy, exploitative, “functionless,” and fundamentally undeserving.

Keynes, in the *Tract on Monetary Reform* (1923), names three public policies to reduce public debt – other than by running annual budget surpluses: 1) repudiation (explicit default), 2) currency depreciation (implicit default), and 3) a capital levy. The first option is, he says, too brazen to be practical or even popular; the latter option, he adds, is too complicated and too avidly opposed by the powerful rich to be adopted.

This leaves currency depreciation (inflation) as the best method the reduce excessive public debt, and not only because it is least understood and least liable to detection by victimized cash-holders and bond-holders. It is, for Keynes, a mere “expedient,” an acceptable policy option. “It is, so to speak, nature’s remedy,” for it “comes into silent operation when the body politic has shrunk from curing itself.”(65) If over-indebtedness is the disease, currency depreciation is the cure.

Given Keynes’s disdain for the reparations obligations imposed on Germany at Versailles, his barely-disguised pleasure is understandable, when he recounts how, by Germany’s deliberate hyperinflation of the mark in 1920-1923, its “national debt has been, by these means, practically obliterated, and the bondholders have lost everything.”(65) For Keynes this is not a policy of injustice but rather of justice, because, he holds, Germany should not have been compelled to pay so much in reparations for
the damage it inflicted during World War I, and because its excessive public obligations hurt the working class, who are taxed to service the debt. Keynes rejects the idea of an “untouchable sacredness of contract,” especially in debtor-creditor relations, for it is only an apology for what he calls “vested interest.”

For Keynes any government can undertake a deliberate yet perfectly legitimate “alteration of the legal tender,” for such an act is neither immoral nor unprecedented; critics of currency depreciation as a means of cancelling public debt tend to overlook, he says, “the greatest of all social principles,” which is the “fundamental distinction between the right of the individual to repudiate a contract and the right of the State to control vested interest.” By his reckoning, “nothing can preserve the integrity of contract between individuals, except a discretionary authority in the State to revise what has become intolerable. The powers of uninterrupted usury are too great. If the accretions of the vested interest were to grow without mitigation for many generations, half the population would be no better than slaves to the other half.”(67)

Keynes here exhibits the standard medieval prejudice against creditors (declaring them usurious), and portrays the currency deprecator not as a legalized embezzler of wealth, but a liberator of debt slaves. Echoing Thomas Jefferson, Keynes declares that no state must be “allowed permanently to enslave the tax-payer to the bond-holder.”(67) A state should care, he says, about “the continuance of an individualist society,” and “must never neglect the importance of so acting in ordinary
matters as to promote certainty and security in business” (68), but, he adds, such values are not worth preserving under extraordinary circumstances, as when a government is over-indebted and its citizens are, thereby, over-taxed. Drawing on utilitarian premises, Keynes insists that “when great decisions are to be made, the state is a sovereign body of which the purpose is to promote the greatest good of the whole.” When expedient, a state must defy the claims of public bondholders and “the absolutists of contract.” (68)

Our proper comprehension of Keynes’s attitude towards public debt and public creditors is enhanced by understanding not merely his disdain for the lender ("rentier") in particular, but also for the gold standard and, more generally, for laissez-faire capitalism, and not only because he insists that they caused the Great Depression. In his 1931 essay, “The End of the Gold Standard” (Keynes 1931, 288-294), he applauds Britain for going off the gold standard, because, he asserts, it handcuffed state actors with “gold fetters” and precluded them from taking the discretionary (and inflationary) actions necessary to cure mass joblessness. On a more ideological level, in his 1926 essay, “The End of Laissez-Faire,” Keynes denies that individuals – least of all the wealthy, especially public bondholders – possess solid rights to liberty or private property:

It is not true that individuals possess a prescriptive “natural liberty” in their economic activities. There is no “compact” conferring perpetual rights on those who Have or on those who Acquire. The world is not so governed from above that private and social interest always coincide. It is not so managed here below that in practice they coincide. It is not a correct deduction from the Principles of Economics that enlightened self-interest always operates in the public interest. Nor is it true that self-interest generally is enlightened; more often individuals acting separately to promote their own ends are too ignorant or too weak to
attain even these. Experience does not show that individuals, when they make up a social unit, are always less clear-sighted than when they act separately. . . . I suggest, therefore, that progress lies in the growth and the recognition of semi-autonomous bodies within the State – bodies whose criterion of action within their own field is solely the public good as they understand it, and from whose deliberations motives of private advantage are excluded, though some place it may still be necessary to leave, until the ambit of men’s altruism grows wider, to the separate advantage of particular groups, classes, or faculties . . . I propose a return, it may be said, towards medieval conceptions of separate autonomies. . . . I think that Capitalism, wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight, but that in itself it is in many ways extremely objectionable. (Keynes 1931, 312-314, 321)

Keynes expressed even more intense disdain for capitalism in a 1933 article, as the Great Depression deepened: “The decadent, international, but individualistic capitalism, in the hands of which we found ourselves after the War, is not a success. It is not intelligent, it is not beautiful, it is not just, it is not virtuous – and it doesn’t deliver the goods. In short, we dislike it and we are beginning to despise it. But when we wonder what to put in its place, we are extremely perplexed.” (Keynes 1933a) It is relevant, in this context, to recall Keynes’s belief, expressed in The Economic Consequences of the Peace (1920, 235), that the “permanent relations between debtors and creditors . . . form the ultimate foundation of capitalism.” His desire to see the world rid of the classical gold standard and laissez-faire capitalism is consistent with his belief that public policy should lighten the public debt burden, by diminishing the rights and returns of public creditors, whether by capital levy, inflation, or a zero-interest-rate policy adopted by the state central bank to effect a “euthanasia” of bondholders.
What is the source of Keynes’s animus toward public bondholders? In part he seems to believe they serve no useful function or productive purpose, and in part he believes they preclude a full recovery from economic depression, by greedily keeping capital unduly scarce and costly. In his *General Theory* (1936) he contends that interest rates are determined not by the interaction of the supply and demand for loanable funds, as the classical economists held, but by the supply and demand for cash balances; thus a central bank might depress interest rates by increasing the supply of money, either by purchasing public debt indirectly from banks, or directly from the Treasury (through debt monetization). Keynes, presuming that the problems of economic depression and mass unemployment reflect a deeper problem of excessive saving, relative to investment, advises a policy of low-to-near zero interest rates, as a way to deter additional saving and foster more investment. In his account,

[This] would mean the euthanasia of the *rentier*, and, consequently, the euthanasia of the cumulative oppressive power of the capitalist to exploit the scarcity-value of capital. Interest today rewards no genuine sacrifice, any more than does the rent of land. The owner of capital can obtain interest because capital is scarce . . . But whilst there may be intrinsic reasons for the scarcity of land, there are no intrinsic reasons for the scarcity of capital. . . . I see, therefore, the *rentier* aspect of capitalism as a transitional phase which will disappear when it has done its work. And with the disappearance of its *rentier* aspect much else in it besides will suffer a sea-change. It will be, moreover, a great advantage of the order of events which I am advocating, that the euthanasia of the *rentier*, of the functionless investor, will be nothing sudden, merely a gradual but prolonged continuance of what we have seen recently . . . Thus we might aim in practice . . . at an increase in the volume of capital until it ceases to be scarce, so that the functionless investor will no longer receive a bonus . . . (Keynes 1936, 376)
For Keynes land is tangible and properly commands rent, but financial capital is not tangible, or at least need not be, and thus it also need not (indeed, should not) command any interest; capital may once have been thought of as derived from savings, especially when it took the form of a tangible commodity like gold, but having now abandoned gold as money, national central banks can easily supplement savings by money-creation. Capital need no longer be scarce. Public finance policy should generate an infinitely-abundant capital supply with no scarcity premium; interest rates can and should be zero, and if possible, even negative, so bondholders, instead of receiving interest, end up paying it over to the state (borrower). The money supply itself should become so abundant as to be virtually costless; in such circumstances, Keynes reckons, no one (least of all the state) need pay any interest, to any would-be bondholder, for the use of cash. A classical economist, of course, finds little logic in such analysis. Keynes himself insists that the cause of depression and mass unemployment is excessive savings and deficient investment – that is, a surplus of idle and hoarded savings – yet he proposes, as a cure, a policy that, as he describes it, would make abundant the “supply of capital,” which means an increase in savings. Yet Keynes recommends an increase not in real savings, but only in the money supply, which is hardly the same thing.

Keynes first publicly advocated a deliberate, peacetime program of deficit-spending in a series of brief articles and essays appearing from 1929 to 1931 (Keynes 1931), a period that began with a troubling rise in Britain’s jobless rate and ended with a
world-reverberating abandonment of the gold standard. Keynes harshly condemns what he calls “orthodox Treasury dogma” (Keynes 1931, 121), a stubborn policy pledge to balance the budget regardless of circumstances, if necessary by severe spending cuts (despite an in-built relief system to subsidize the jobless) and tax hikes; the “dogma” also entailed a pledge to keep the pound sterling convertible into gold, without devaluation, even if that meant growth-crushing deflation and still greater joblessness. Writing in April 1929, after a year in which Britain’s jobless rate jumped from 10% to 12%, and five months before U.S. stock prices crashed, Keynes blames the joblessness on Treasury’s intransigent, dogmatic commitment to financial orthodoxy, and its refusal to deficit-spend in a deliberate and overt manner; since 1920 annual British outlays had been cut by 34%, and surpluses permitted the public debt to be cut 3%, but the jobless rate stayed above 10%. To stop “retarding for a decade the economic progress of the whole country,” Keynes urges the British government to spend aggressively and at will, and “even if half of it were to be wasted, we should still be better off.” Regarding government’s more “productive” spending schemes, Keynes rejects worries that “money raised by the state for financing [such schemes] must diminish pro tanto the supply of capital available for ordinary industry.” (Keynes 1931, 120-121)

Contrary to the “Treasury view,” Keynes insist that public capital spending schemes will not displace more productive private capital or employment; resources are already badly under-employed, and slack in the system will prevent crowding out as
well as inflation and any run on the pound, or threats to the gold standard. The Bank of
England should help expand money and credit.

Keynes believes Britain’s persistently high jobless rate in the 1920s is being
exacerbated by Treasury’s obsession to reduce the high levels of public debt and interest
rates remaining from World War I. “The less the government borrows, the better, they
argue, are the chances of converting the national debt into loans carrying a lower rate of
interest,” but in doing this Treasury officials only “barred the door” to recovery. (Keynes
1931, 129) In early 1931 Keynes warns households and business against saving more in
hard times; paradoxically, he says, private thrift may seem prudent, but collectively,
when resources are underemployed and savings are already excessive, recovery requires
less thrift and more spending. (Keynes 1931, 151-153) Later in 1931, on the eve of
Britain’s default on the gold standard, Keynes denounces a Treasury plan to narrow a
budget deficit, and preclude public borrowing, by spending cuts and tax hikes; the
policy is traced to “the crude idea that there is a fixed loan fund, the whole of which is
always lent, so that, if the government borrows less, private enterprise necessarily
borrows more.” Keynes, we have seen, rejects the notion of “crowding out.” Treasury’s
orthodox approach will worsen joblessness; Treasury instead should simply deficit-
spend. “The immediate consequences of the government reducing its deficit are the
exact inverse of the consequences of its financing additional capital works out of loans.”
Fear not, he tells Treasury; be bold, and reject the notion that deficit-spending must be
artificial, unsustainable, or harmful. “At the present time all governments have large
deficits,” yet public borrowing is really “nature’s remedy, so to speak, for preventing
business losses from being, in so severe a slump as the present one, so great as to bring
production altogether to a standstill,” even though it is also “much better in every way
that the [state’s] borrowing should be for the purpose of financing capital works, if these
works are of any use at all, than for the purpose of paying doles,” that is, for direct relief
of the unemployed. (Keynes 1931, 158, 159, 161)

Keynes further advanced his case for peacetime deficit-spending in a 1933
pamphlet, *The Means to Prosperity*. He advised the British government to make an extra
£3 million “loan-expenditure” – his expression for what later became known as “deficit
spending” – which was then less than 1% of total government spending of £1.3 billion,
when Britain had roughly one million unemployed. Keynes assumed a modest
spending multiplier (1.5). Trying to balance the budget by tax hikes, as the U.S. tried in
1932, would only make things worse: “Taxation may be so high as to defeat its object,”
he write; indeed, “given sufficient time to gather the fruits, a reduction of taxation will
run a better chance, than an increase, of balancing the budget.” Alternatively, by a
deliberate “loan-expenditure,” the state could “support schemes of capital development
at home as a means to restore prosperity.” In the past, Keynes says, only war had
justified deficit-spending, but now a peacetime economic contraction also does so:

If these conclusions cannot be refuted, is it not advisable to act upon them? The
contrary policy of endeavoring to balance the budget by impositions, restrictions,
and precautions will surely fail, because it must have the effect of diminishing
the national spending power, and hence the national income. . . . Some cynics,
who have followed the argument thus far, conclude that nothing except a war
can bring a major slump to its conclusion. For hitherto war has been the only
object of governmental loan-expenditure on a large scale which governments
have considered respectable. In all the issues of peace they are timid, over-
cautious, half-hearted, without perseverance or determination, thinking of a loan
as a liability and not as a link in the transformation of the community’s surplus
resources, which will otherwise be wasted, into useful capital assets. I hope that
our Government will show that this country can be energetic even in the tasks of
peace. (Keynes 1933b)

Later in 1933 Keynes again opines publicly on the possibility of a coordinated
policy to deliberately enact peacetime deficit-spending, when The New York Times invites
and then publishes his open letter to U.S. President Roosevelt. Keynes argues for placing
recovery measures before reform (regulatory) efforts, because the latter are undermining
business confidence. Since confidence is low and consumer spending “cannot be
expected to work on a sufficient scale,” Keynes says the only way to create an “initial
major impulse” and get the economy growing again is by inflationary deficit-spending:

The public authority must be called in aid to create additional current incomes
through the expenditure of borrowed or printed money. . . . As the prime mover
in the first stage of the technique of recovery I lay overwhelming emphasis on
the increase of national purchasing power resulting from governmental
expenditure which is financed by Loans and not by taxing present incomes.
Nothing else counts in comparison with this. . . . [I]n a slump governmental Loan
expenditure is the only sure means of securing quickly a rising output at rising
prices. . . . In the past orthodox finance has regarded a war as the only legitimate
excuse for creating employment by governmental expenditure. You, Mr.
President, having cast off such fetters, are free to engage in the interests of peace
and prosperity the technique which hitherto has only been allowed to serve the
purposes of war and destruction. The set-back which American recovery
experienced this autumn was the predictable consequence of the failure of your
administration to organize any material increase in new Loan expenditure during your first six months of office. (Keynes 1933c)

As mentioned, there is remarkably little in Keynes’s General Theory that speaks directly, or extensively, to deficit-spending or public debt, despite his reputation, to this day, as an aggressive advocate of such a policy. Keynes was certainly aggressive in advocating that government undertake the vast bulk (more than half) of all investment in the economy – “a somewhat comprehensive socialization of investment will prove the only means of securing an approximation to full employment” (Keynes 1936, 378) – and not only during economic contractions. Yet Keynes did not explicitly advocate deficit-spending as a way to achieve a cyclical rebound, nor did he recommend a permanent, structural budget deficit or large build-up of public debt. We know, from his own works, that were an onerous public debt burden to arise, he would advise default, or a capital levy, or the subterfuge of inflation; but nothing in Keynes explicitly requires a greater public debt, let alone a rising proportion of public debt relative to national income. He wishes the “rentier” class of bondholders will not gain in importance (or in asset holdings), and that their role will diminish; indeed, he prefers that the rentier class wither away and die, along with the classical gold standard and laissez-faire capitalism.

To the extent Keynes condones budget deficits in the face of recessions or depressions, he does so mainly to counteract the potential harm that can be inflicted by the usual orthodox (classical) prescription that government budgets be balanced in
peacetime, a policy which, during contractions, requires vast public spending cuts, tax hikes, or both. For Keynes such policies only hurt the economy – indeed, in the U.S. they had been Hoover’s policies in the early 1930s – and here Keynes was right (at least as to tax hikes). But his opposition was not co-extant with an aggressive advocacy of massive deficit spending to spur recovery; accruing to Keynes, a genuine, sustainable economic recovery required vast new public investment, not more deficit-spending per se.

There is, however, a section of the *General Theory* which gives the careful reader the impression that Keynes is cavalier about deficit spending – indeed, an avid proponent of wasteful deficit spending – to achieve economic recovery and job creation. “When involuntary unemployment exists,” he claims, “the marginal disutility of labor is necessarily less than the utility of the marginal product,” although he does not explain why such a condition would fail to induce the jobless to take work; normally one wishes to work an extra hour as long as the utility to gained exceeds the extra disutility of laboring – precisely the case Keynes describes. He concludes that “if this [assumption] is accepted, the above reasoning shows how ‘wasteful’ loan expenditure [i.e., deficit-spending] may nevertheless enrich the community on balance. Pyramid-building, earthquakes, even wars may serve to increase wealth . . .” (Keynes 1936, 128-129).

Conceding that these may appear to be “absurd conclusions,” nevertheless Keynes chides those who demand budget balance while condoning “employment relief financed by loans,” which he designates a “wholly wasteful” form of spending, and
while opposing “the financing of [infrastructure] improvements,” which he classifies as only a “partly wasteful” form of public spending. (Keynes 1936, 129) “It would, indeed, be more sensible to build houses and the like,” via deficit spending, but the orthodox budget-balancers oppose it, and tragically, “wars have been the only form of large-scale loan expenditure which statesmen have thought justifiable.” (Keynes 1936, 129-130) He ridicules orthodox budget-balancers for opposing deficit-financed public homebuilding while condoning debt-financed jobless subsidies that entail the building of nothing, all the while posing as “prudent financiers” who urge policymakers to take “careful thought before we add to the ‘financial’ burdens of posterity” by accumulating public debt. Worse still, he might have added, are those Hoover-type budget-balancers who so raise tax rates as to deepen contractions and cause still larger deficits and debt.

Another passage in the General Theory leaves Keynes exposed to the charge of being pro-active about deficit spending as a cure-all for depression. He tells readers that the phrase “loan expenditure” should encompass two distinct types of state spending – the first being “public investment” (viz., spending on infrastructure, which he describes as only “partly wasteful”), the second being “current public expenditure” (viz., spending on jobless subsidies and income transfers, which he describes as “wholly wasteful”). Although “loan expenditure” is a “convenient expression for the net borrowings of public authorities” and encompasses both types of deficit-spending, “on all accounts, whether on capital account or to meet a budgetary deficit,” yet, “strictly speaking, the
latter should be reckoned as negative saving,” for whereas “one form of loan expenditure operates by increasing investment,” the other operates “by increasing the propensity to consume.” (Keynes 1936, 129) Here deficit spending appears as a cure-all—precisely because it is “wasteful” (i.e., a destroyer of supposed wealth “gluts”).

Recall that for Keynes, depression and “involuntary unemployment” occur when an economy’s aggregate supply exceeds its aggregate demand, and does so because savings exceed investment. The capital market does not clear; interest rates do not fall. The relative deficiency of aggregate demand reflects a relative deficiency of investment. But Keynes claims to locate two policy-oriented methods of achieving the necessary balance and reaching full employment: 1) boost investment, so it is no longer deficient, by deficit-spending on public investment (capital goods) and 2) reduce saving, so it is no longer superfluous, also by a policy of deficit-spending, but solely for the benefit of those people with a greater propensity to consume than to save (ideally, recipients of jobless subsidies). When deficit spending is presented as the cure not just for some aspects of what ails a depressed economy but for all sides of its most crucial equation (saving=investment), the policy is sure to be used extensively—perhaps even perpetually, especially when economists also believe “full employment” is a rarity.

The last bit of evidence bearing directly on Keynes’s own view of deficit spending and public debt comes from his insistence that government outlays be partitioned into an account for ordinary spending and another account for capital
spending, as is done in the business world. Ideally, says Keynes, the ordinary spending budget would be covered fully by tax revenues, with no annual deficit, but outlays in the capital budget would be borrowed, on the grounds that public investment yields longer-term benefits to posterity. According to Batemen (2005), Keynes did not raise this distinction as a ploy to rationalize open-ended deficit spending; he first wrote about the need for the distinction in 1924, and last wrote about it in 1944, in the British White Paper on Employment Policy. Keynes insisted that “the ordinary Budget should be balanced at all times” and argued against “confusing the fundamental idea of the capital budget with the particular, rather desperate expedient of deficit financing.” Not merely an ordinary budget balance but on occasion even a surplus would be welcome, to Keynes. “I should aim at having a surplus on the ordinary Budget,” and thus the capacity of “gradually replacing dead-weight debt by productive or semi-productive debt. . . . I should not aim at attempting to compensate cyclical fluctuations by means of the ordinary budget.” (cited in Bateman 2005, 187-188)

Here we find Keynes, the supposed apologist for chronic deficit-spending and an accumulating public debt, characterizing deficit-spending as a “desperate expedient,” and calling for a surplus in the annual operating budget, to retire what he calls the “dead-weight” burden of the national debt; moreover, he denies that deficit-spending, at least in the ordinary budget, should be used to “compensate cyclical fluctuations.” As
we will see, many Keynesians came to advocate schemes of “compensatory finance,” or “functional finance,” out of the ordinary budget, in the manner Keynes himself rejected.

Keynes believes that the failure to establish the key distinction between the operating budget and capital budget, and the refusal by fiscal officials to incorporate the distinction in their formal budgeting practices, leads to over-loose fiscal policies and excessive budget deficits. There is always a question, of course, about how to classify outlay categories that share both features (ordinary outlays and capital outlays), and whether definitions are to be fixed for all time or instead subject to expedient manipulation; yet supposing such questions to be resolvable, it seems that a key objective, for Keynes, is to achieve a more accurate and comprehensive fiscal reckoning. If there was to be, as Keynes hoped, a vast increase in the “socialization of investment” by the state, it required a more business-like accounting system that could responsibly measure and track public capital projects, and would not automatically reject such projects on the grounds that they un-balanced the operating budget. Yet critics might also reasonably suspect that Keynes fought for the distinction in order to appear fiscally conservative on one front (the operating budget), so he could secure political approval for fiscal liberality on another front (the capital budget). The latter front was far more important to Keynes, given his belief that the best remedy for economic depression and mass unemployment was spending on public capital projects, without any attendant
tax-hiking; he needed to justify deficit-spending on this key front, in the face of a lingering, classically-inspired opposition to unbalanced budgets in peacetime.

Although we have restricted our focus to the history of public debt theory primarily in the Anglo-America world, it is worth noting, here, that something of a proto-Keynesian viewpoint was developing already, in Germany and beyond, in the decades after the first public finance writings of Carl Dietzel (1829-1884) appeared in the mid-19th century. (Stettner 1948, Peacock 1987, Samuels 2003) By one account, Dietzel’s major work in 1855 “attacked the orthodox [classical] view that state borrowing required a sinking fund, arguing that government investment financed by renewable loans was a necessary condition for the growth in national production.” Moreover, Dietzel’s theories “were endorsed by several prominent German writers, notably Adolph Wagner, and were recalled during the post-1936 debate in support of Keynesian views on public debt policy.”(Peacock 1987, 837). Another source relates how Dietzel rejected the view that “the public sector is outside of the overall economy and that all public expenditures are unproductive,” in other words, the “two premises” by which “the classical doctrine logically had to oppose a system of public debt.” (Samuels 2003, 84). Dietzel also held that “only democratic states are normally creditworthy,” that “non-democratic, absolutist states, in general, could only borrow if their governments managed their economic affairs effectively, and therefore are not exposed to economically unfavorable political pressures and/or other corruptive fiscal practices.” (Samuels 2003, 87) Dietzel
also argued for a perpetual public debt, believing it benefited the economy, and denied that rising public debt burdened future generations, as long as it was incurred solely to fund public capital projects, not wasteful consumption schemes or income transfers. Finally, Dietzel denied that there were any inherent limits beyond which public debts might rise. Many of his ideas were imported into leading British and American universities during the wave of student exchanges in the late 19th century.

Keynes’s intellectual roots were, paradoxically, both primitive (pre-Smithean) and “modern” (appropriate to the spread of statism in the 1930s). In Chapter 23 of his *General Theory* (1936) – titled “Notes on Mercantilism, the Usurer Laws, Stamped Money, and Theories of Underconsumption” – he reveals his roots: 16th and 17th century mercantilism, early-19th century Malthusian glut theory, and early 20th century promotion of inflationary money-printing (*viz.*, by Silvio Gesell) as a way to tax cash hoards and reduce interest rates. By one account, Keynes’s “pump-priming” theories and policies were more than a century old, at the least, since “Malthus had anticipated certain aspects of pump-priming theory” “as a remedy for depressed conditions” after the War of 1812. (Clay 1944, 144) The famous British Fabian socialists, Sidney and Beatrice Webb, also advocated the policy, more than two decades before Keynes, in a book on “the prevention of destitution.” (Webb and Webb 1911, especially Chapter VI, “How to Prevent Unemployment and Underemployment”). By another account, “countercyclical policies,” eventually labeled “Keynesian policies,” were touted “in the
early 1930s,” “in various quarters before the appearance of the General Theory,” “by various individuals and groups,” especially by “German advocates of deficit spending,” as “a road to full employment.” (Garvy 1975, 393n3, 396) According to one scholar, “no more than Roosevelt did Hitler have to await the publication of the General Theory to embark on expansionary policies,” for “G. Strasser, G. Feder, and others in Hitler’s party had already offered the prescription.” (Garvy 1975, 403).

By the early 1930s Keynes had become both influential and acceptable to Weimar economists and nationalists due to his previous, sympathetic case (in 1920) for Germany in the post-war debate about reparations burdens, but ideological compatibility was also a relevant factor: in his specially-prepared introduction to the 1936 German-language edition of his General Theory, Keynes declared that “the theory of output as a whole, which the following book purports to provide, is much more easily adapted to the conditions of a totalitarian state, than is the theory of production and distribution of a given output produced under the conditions of free competition and a large measure of laissez-faire.” (cited in Garvy 1975, 403) Neither the rise of Hitler, Mussolini and Stalin nor the expansion of the welfare-warfare-regulatory states in the U.S. and Britain in the 1930s and 1940s dimmed Keynes’s passion for central planning, the socialization of investment, and deficit-spending; in his view a benign “middle course” between capitalism and socialism was needed to prevent collapse of the former and forestall adoption of the latter. For Keynes, state interventions would not necessarily proliferate
beyond all rational check, although such a necessity was precisely the theme of Friedrich Hayek’s *The Road to Serfdom* (1944); upon reading it, Keynes wrote to Hayek that while “it is a grand book,” “I should say that what we want is not no planning, or even less planning; indeed, I should say that we almost certainly want more,” and “what we need” “is not a change in our economic programs” but “an enlargement of them.” (cited in Wapshott 2011, 198-199)

Keynes might have described the classical economists as insisting on “balancing the budget, the economy be damned,” while he insists on “balancing the economy, the budget be damned.” Yet he was no advocate of unmitigated deficit spending. Distinguishing the ordinary from the capital budget, he sought to reconcile old (classical) and new (his) notions of fiscal integrity. It was still possible, perhaps likely, in summing each, to get aggregate deficit spending, especially amid recessions. Yet public capital projects would yield a return, said Keynes; but since outlays were to be guided by the criterion of the “public good,” not by private interest or the profit motive, such a return would rarely prove so high as to satisfy a net-benefit test, or exceed the cost of capital (in this case public capital), as required in purely private projects. Yet for Keynes this difference was precisely the advantage of public capital projects: with lower, more lenient hurdle rates, investment (hence economy growth) would be less volatile.

Indeed, Keynes argued that long-term economic stability and the elimination of involuntary unemployment required that most (66-75%) such outlays be state-controlled
(and comprise up to 20% of GDP). “If two-thirds or three-quarters of total investment is
carried out or can be influenced by public or semi-public bodies,” he stated, “a long-
term program of a stable character should be capable of reducing the potential rage of
fluctuations to much narrower limits than formerly, when a smaller volume of
investment was under public control, and when even this part tended to follow, rather
than correct, fluctuations in investment in the strictly private sector of the economy.”
(cited in Brown-Collier and Collier 1995, 342-343) In contrast to the capital budget,
which would be funded mainly by borrowing, not taxes, in the operating budget Keynes
mostly opposed deficit spending. As for these “other forms of deficit financing,” he
wrote, “I am inclined to lay low because I am sure that if serious unemployment does
develop, deficit financing is absolutely certain to happen, and I should like to keep free
to object hereafter to the more objectionable forms of it.” (cited in Brown-Collier and
Collier 1995, 344) Critics of Keynes’s views on deficits might be surprised to learn that he
found some deficits to be “objectionable.” That deficit-spending is justified mainly for
public capital outlays, not consumptive or transfer spending from the ordinary
operating budget, is stressed also by Musgrave (1939) and Eisner (1986 and 1989).

What was Keynes’s expectation about the likely effect of his deficit-friendly
policies on the national debt? Just as he distinguished between an operating budget that
should be funded by tax revenues and balanced over the course of the trade cycle, and a
capital budget that necessarily would be unbalanced, he also distinguished between
non-productive, or “dead-weight” public debt (related to the operating budget) and “productive” public debt (associated with the capital budget). He proposed less of the former debt and more of the latter, declaring that it would be “a good plan” to include in the operating budget a line item to spend a sum each year for “the extinction of the dead-weight debt” or “the conversion of the dead-weight debt into productive debt.”

Yet the debt associated with the capital budget would rise on its own to match growth in the economy and its capital needs. Thus by his own analysis, and assuming adoption of his policy advice, Keynes (writing in the early 1940s) expects “for a long time to come that the government debt or government-guaranteed debt would be continually increasing in grand total,” yet not “out of proportion to the growth of the national income.” (cited in Brown-Collier and Collier 1995, 349) Beyond his initial assessments in *The Economic Consequences of the Peace* (1920), Keynes seems nowhere to have been very much concerned about excessive public obligations or debt default trigger points.

By the early 1940s economists could discern the profound alteration in viewpoint that had occurred over the prior decade. Public deficits and debts, while not themselves novel, were now being reinterpreted in a seemingly novel way: previously they were seen as a natural although unfortunate result of economic depression, but now they were viewed as a crucial means of recovery. Haley (1941, 67) described the change thus:

There is nothing new about deficits for government units in time of depression. In such periods it is to be expected that government receipts will decline, while expenditures fail to decline proportionately, or even increase. There is, however, a difference between a fiscal policy designed simply to alleviate the distress
accompanying a severe depression and a fiscal policy designed to produce recovery though a deliberate unbalancing of the budget. The former policy is based on the assumption that the deficit is the lesser of two evils; the latter, on the assumption that deficit financing in such a period is a positive good. It is the latter policy which has been followed since 1933. The new aspects of our recent deficits have been their extraordinary size, for peacetime, and the complacency with which they have been incurred. They have been viewed as a necessary and important means of promoting recovery itself.

On the whole Keynes is sanguine about deficit-spending and the capacity of developed nations to safely implement the policy, even in peacetime, so he might be classified as a public debt optimist; yet more than a few passages in his work carefully delimit, albeit ambiguously, the proper extent and magnitude of such spending. To this extent Keynes is more a realist on public debt. Yet it is difficult to discern whether these passages reflect his genuine views or instead a cynical, opportunistic effort to assuage the suspicions of inveterate budget balancers. Regardless, Buchanan and Wagner (1977) classify Keynes as a proponent of “continuing and increasing budget deficits.”

Having investigated Keynes’s views directly, we now have some reason to doubt this cavalier assessment. Yet even such critics of Keynes’s views as Buchanan and Wagner (1977) do not contend that he is solely responsible for the material sea-change in professional and political attitudes about public deficits and debt during the 20th century. “There was no full-blown Keynesian ‘revolution’ in the 1930s,” write Buchanan and Wagner (1977), for “American acceptance of Keynesian ideas proceeded step by step from the Harvard economist, to economists in general, to the journalists, and finally, to
the politicians in power. This gradual spread of Keynesian notions” not coincidentally, accompanied “the demise of the old-fashioned principles of fiscal responsibility.”(6)

There is a valid question, then, as to whether the shift in thinking and practice on deficits and debts – viz., should they be temporary and rare, or long-lasting and typical? – was but a logically consistent elaboration and extension of Keynes’s views, or rather a departure from them. In his 1954 text, *Principles of Public Finance*, the pro-Keynesian and one-time British finance official, Hugh Dalton argues that indeed there is a fiscal revolution, and on his telling, it is attributable mainly to Keynes:

> The new approach to budgetary policy owes more to Keynes than to any other man. Thus it is just that we should speak of the “Keynesian revolution.” . . . We may now free ourselves from the old and narrow conception of balancing the budget, no matter over what period, and move towards the new and wider conception of balancing the whole economy (Dalton 1954, 223).

Given what we have found in Keynes directly, Dalton’s account seems too sweeping; Keynes certainly wanted to “balance the economy,” in wanting to eliminate involuntary unemployment, through a balancing of savings and investment (lowering the former and boosting the latter), and by means of deficit-spending on public capital outlays. But Keynes did not endorse deficits in the operating budget, let alone permanent deficits; indeed, he advised a surplus in the ordinary budget. The assessment by Brown-Collier and Collier (1995) is more accurate; they write of how

> It is commonly believed that Keynes’s primary policy prescription for economic stabilization and full employment is federal government deficit spending [but his] policy for promoting full employment or reducing economic fluctuations
was the socialization of investment. Any connection between his policy proposal and deficit spending was related to the choice of funding such social investment. The policies pursued in the United States over the last forty years [1955-1995] have not been consistent with Keynes’s proposals for economic stabilization and have caused ever increasing deficits and financial instability. (341)

A more recent assessment, which also rejects the stereotypical depiction of Keynes as an aggressive advocate of deficit-spending, comes from Allan Meltzer (2010), a long-time monetarist and Keynes interpreter. Meltzer contends that Keynes was no proponent of large and long-lasting budget deficits or of fast-accumulating public debts, and that those contemporary economists, journalists and politicians who insist that he was misconstrue the true meaning of Keynes’s original fiscal message:

Keynes was opposed to large structural deficits. He thought that they chilled rather than stimulated the economy. . . . Keynes understood what the [Obama] administration doesn’t understand – that the proper policy in a democracy recognizes that today’s increase in debt must be paid in the future. We paid down wartime deficits. Now we have continuous deficits. We used to have a rule people believed in: balanced budgets. And now that’s gone. . . . Keynes wanted deficits to be cyclical and temporary. He wouldn’t have been in favor of efforts to raise tax rates in a recession to eliminate deficits. He viewed that as suicidal. He was opposed to the idea that governments should balance the budget during a downturn, and advocated running short-term deficits to spur the economy. The type of stimulus he advocated was very specific. He said it should be geared towards increasing private investment. He viewed private investment, as opposed to big government spending, as the source of durable job creation. He also said that the deficits should be self-liquidating, so that the increased economic activity caused by the stimulus inevitably generated a combination of extra tax revenues and lower unemployment payments. With higher revenues and lower outlays, the deficit would disappear. . . . Keynes wanted to increase employment by smoothing the amount of investment through the up and down parts of the business cycle. He knew that recessions cause a decline in investment, and that the fall in investment caused unemployment to rise. So he
wanted the government to stabilize investment through a recession. . . . He believed that the government should plan and direct investment, but not nationalize it. . . . He said [budget] deficits should be temporary and self-liquidating. He clearly did not advocate long-term spending in excess of revenues, since that causes structural deficits. (Meltzer 2010)

Meltzer’s account seems more in keeping with what Keynes actually said and wrote about public deficits and debts, compared to Dalton’s account, and perhaps this is an ironic difference, since monetarists like Meltzer traditionally are critics of Keynes’s ideas and policies, while Keynesians like Dalton typically are defenders of same.

Certainly monetarists have critiqued the Keynesian system on the grounds that it overstresses the power of fiscal policy relative to monetary policy, but having assessed some of Keynes’s views on money and its deprecation relative to the value of public debt and the level of interest rates, we discern a Keynes who contends that monetary policy can be very powerful indeed and can do some cyclical good in a downturn.

Meltzer’s criticism is really not of Keynes’s views directly but of those of the Keynesians who followed him; in Meltzer’s view, these followers have misinterpreted and misused Keynes’s theories, at least on the issue of government deficits and debts. Thus it is to these Keynesians that we turn next, to discern what they actually propound in this area.

4.4 Secular Stagnation and the Possibility of Permanent Growth in Public Debt: Alvin Hanson

After the publication of Keynes’s General Theory in 1936, the Keynesians who theorized most about deficits and public debt, and who exerted the greatest influence on
professional-journalistic thinking and government policy regarding public debt, include
Alvin Hansen (1887-1975), Abba Lerner (1903-1982), Seymour Harris (1897-1974), James
Meade (1907-1995), and Richard Musgrave (1910-2007). Paul Samuelson (1915-2009) and
Paul Krugman (1953-) have played lesser roles in the debate, as they did not specialize in
public debt theory, but they had broader influences and reputations. We shall devote
only minor space to Musgrave, Samuelson and Krugman, not because they have not
been influential on public debt, but because they have not been originators; in providing
textbook-oriented explications of Keynes’s debt theory, they have mainly popularized it.

A major thematic innovation on Keynes’s thinking about deficit-spending and
public debt was made by Alvin Hansen (1887-1975), a professor of political economy at
Harvard from 1937 to 1957, who became known as “the American Keynes” and whose
Fiscal Policy Seminar trained many new upstart Keynesians. According to the late-
Richard Musgrave, the most prominent of the Keynesians specializing in public finance
in the 20th Century, “Hansen, in his fifties at the time [1937-1947], rose to the occasion . .
. Quick to shed old preconceptions and to move to the center of new thought, [Hansen]
held a Fiscal Policy Seminar [at Harvard)] in the late thirties that became the catalyst for
the development of the new [Keynesian] ideas. Many of the leading economists of later
years were trained there. What has long since become a matter of introductory
economics still seemed full of mystery.” (Musgrave 1975)
In fact, Hansen’s initial review of Keynes’s *General Theory* was not laudatory. He complained about “Keynes’s failure to give exact definitions and to employ them consistently.” (Hansen 1936, 676) He concludes that “the book is more a symptom of economic trends than a foundation stone upon which a science can be built.” (Hansen 1936, 686). Yet he cautiously endorses Keynes’s core claim that an economy can settle down to an equilibrium of severe underemployment, that the problem arises from excessive savings, and can be cured by what may seem like a reckless policy. As Hansen puts it: “While a puritanical policy of thrift and saving may be quite appropriate in a society in equilibrium at full employment, prodigality may be the appropriate social virtue in a society in equilibrium at underemployment.” (Hansen 1936, 671)

Like Keynes, Hansen concedes that labor markets might clear and structural joblessness could end, without risking a deeper contraction, if only wage rates were to adjust and decline, but, he says (echoing Keynes – and labor union leaders) this is no longer socially or politically acceptable. Thus again he concurs, with Keynes, that cures should include the redistribution of income (from those who save relatively more, to those who consume relatively more), a very low rate of interest, and a vast socialization of capital investment by government using borrowed funds. It is this last policy that Hansen later extends and expands, in a full-fledged case for nearly limitless deficit-spending and public debt accumulation, even though his 1936 review says nothing more on this topic. Hansen does contend, however, and uncritically, that Keynes’s proposal
for a vast socialization of capital spending entails “forced investment” by “artificially contrived measures,” that the policy “goes far in the direction of a planned economy,” and that it “might, indeed, lead straight into a thoroughgoing socialism,” but “whether or not Keynes’s proposals will in fact prove effective,” “it is clear that they are currently popular and are likely to be tried on an expanding scale,” because “modern communities appear to be in the proves of reverting to the behavior patterns of the pre-capitalistic period.” Hansen knows that deficit-spending can prove popular in a democratic setting, even though it might also lead to “thoroughgoing socialism.” This conforms closely to what we’ve already seen of Keynes’s personal disdain for capitalism.

What later would be dubbed the “new economics” of Keynes was not, Hansen insisted in 1936, new at all, for “Keynes’s economic system is, as he himself admits, a reversion to the economic doctrines of mercantilism.” (Hansen 1936, 682-683) As late as 1953, in his guidebook to the General Theory, Hansen commended Keynes because “he did not hesitate to advocate loan expenditures,” but he also complained that Keynes only attacked the “dogma” of budget balance, and “rather vaguely,” that he “never faced up to the debt problem,” and never explored “the implications of a growing public debt,” “the problems of debt management,” or “the important role of public debt as a means of providing adequate liquidity in a growing economy.”(Hansen 1953, 219)

On public debt theory, Hansen effectively extends Keynes’s insights from the realm of the short-term, the cyclical and the temporary, to the realm of the long-term, the
secular, and the permanent. As Keynes’s argued, aggregate demand could be deficient temporarily, by a shortfall of investment relative to savings, but according to Hansen it could also be deficient permanently; if so, the cure must also be extended. If deficit spending boosts investment in the short-term, it may do so in the long-term, too. In the late 1930s Hansen advances a thesis that came to be known as “secular stagnation,” sometimes called “economic maturity.” (Hansen 1939) Observing the prolonged economic stagnation and persistently high jobless rate of the 1930s, he worries that such conditions might prove indefinite. He surmises that long-term (secular) stagnation is slowly taking hold in the developed world (i.e., there were inherent “limits to growth,” long before the phrase became common, in the 1970s) due to a steady diminution in the prerequisites of growth and full employment – *viz.*, the American frontier, population growth, and technological innovation. For Hansen there is not only a cyclical and temporary deficiency of private investment opportunities (relative to savings), but a chronic and permanent deficiency, too.

In some sense Hansen’s secular stagnation thesis is a mere elaboration of Keynes’s notion of an underemployment equilibrium, albeit adapted to a longer-term context; yet it was crucial to advancing an argument which Keynes himself did not seem to make: a case for perpetual deficit-spending and even an ever-rising Debt/GDP ratio. Recall that Keynes’s cure for a cyclical shortfall of investment relative to savings was deficit-spending on public capital goods; for Hansen, this cure is valid, but it should be
applied as well to the persistent stagnation he claimed to see in the late 1930s. If adopted, the policy would boost total public debt, but potentially, also, raise the proportion of such debt to GDP, since secular stagnation meant slow or non-existent growth in GDP (the denominator of the debt ratio). Hansen’s stagnation thesis lost influence in the 1940s, amid criticism and war, but it was revived in the 1970s. He held fast to the thesis, at least until 1954, only a few years before retiring from Harvard. “The dogma of the balanced budget may well become a serious obstacle to maximum production, employment and purchasing power in the United States,” he then wrote. “Yet it is by now generally agreed that the present public debt, considering the manner in which it is held (combined with the current relatively favorable distribution of the tax burden), is an important element of strength in the community,” and it is crucial, for “full employment in the United States is not likely to be maintained, either in the cyclical short run or the long run, unless the massive fiscal powers of the federal government are employed to ensure adequate aggregate demand,” “not merely as an anti-cyclical device, but also as a necessary means to achieve our long-run growth potential.”

(Hansen 1954, 412-413)

In the late 1930s fear of secular stagnation were felt not only by Hansen but by a range of New Deal economists and reformers. Despite a cascade of deficit-spending – from 1931 to 1937, 45% of all federal spending was borrowed, and the national debt had doubled – by mid-1938 the U.S. jobless rate was still 21%, up from 14% a year earlier,
and industrial output was down 31% over the same period year; this was a depression within a depression-dominated decade. Socialist ideas and interpretations were ascendant in the 1930s, for it seemed capitalism was finally collapsing, as Marx and Engels had first forecast in 1848; the depression gave credence to the notion of secular stagnation, purportedly due to the system’s diminishing capacity to exploit the worker. Recall that Hansen’s 1936 review of Keynes’s *General Theory* had detected certain socialist-oriented policy implications (on public investment), and how, in the 1950s, Hansen still believed secular stagnation was an inherent risk, but that perpetual deficit finance could prevent it. Socialists generally agreed with Keynes and Hansen that stagnation was spreading, but insisted it reflected capitalism’s inevitable, pending demise, and that it was useless even to try to forestall it by futile deficit-finance schemes. Keynesian policy, they noted, sought to lower savings and boost consumption, by deficit spending, but the inevitable rise in public debt only meant higher future taxes on consumers and still-more interest income paid to exploitative public bondholders – a final, desperate, self-defeating attempt to redistribute wealth upward (Braverman 1956).

Facing such socialist taunts in the late 1930s, Keynesians nonetheless bravely soldiered on, with new polemical ammunition insisting that deficit finance could cure stagnation. A short volume in 1938, from seven economists (“younger instructors”) from Harvard and Tufts, titled *An Economic Program for American Democracy*, argued for a vast new expansion of government deficit spending and insisted that there was effectively no
limit to the amount of public debt a nation might safely incur (Gilbert 1938). Without citing Hansen or Keynes, the authors nevertheless advance their main propositions, in an extreme form: secular stagnation is taking hold, due mainly to excessive savings and deficient investment, and it is curable only by a still greater magnitude of government deficit spending than even the New Deal had spawned. “The task of raising money for these expenditures is much less formidable than it appears,” say the authors (Gilbert 1938, 53); both taxes and public borrowing should be increased – the latter indefinitely:

The long-range public investment program should be financed chiefly through borrowing. This will of course mean a steadily increasing total of public debt. To many people – perhaps to most people – the prospect is terrifying. The public debt, they say, cannot continue to increase forever. The government will never be able to pay it back. The burden of taxation will eventually become intolerable. These and other apprehensions are the result in part of confusion, in part of hostility to the extension of conscious social action in the economic sphere. Much of the widespread confusion on the subject of debt arises from an understandable tendency on the part of the average person to reason from his own personal experience. The wage earner, the salaried worker, and the farmer know that so far as they are concerned debt usually means trouble. They certainly cannot go on increasing the amount of their debts indefinitely. . . . They know, too, that any increase in their debts inevitably means the deduction of an additional slice from their income to meet interest payments. No wonder they consider debt something to be avoided and look with alarm at the continued increase in the debt of the whole nation. Few people are accustomed to thinking in terms of the economy as a whole, much less in terms of the economy as an expanding organism. They could scarcely be expected, therefore, to realize that what applies to personal debt does not in the least apply to the business and public debt of the entire nation. The fault lies not with them but rather with the economists and publicists who have failed in their responsibility of educating the public on so important a matter. If we look at the whole nation as a going concern, we see that its internal debts, business and governmental, are merely another aspect of its assets. Debt in the broad sense is the obverse of investment. . . . Individual debtors do, of course, get into trouble by improvident borrowing. But for the economy as a whole, trouble comes only when the nation falters in the course of
its economic expansion. Only in periods of crisis and depression is there a general questioning of the solvency of debtors. The expansion of debt at a rate sufficient to absorb the nation’s savings is both sound and necessary. This rate could be excessive only in the sense that the rate of savings itself was excessive. Thus, what we should worry about is not the increase in the debt but the increase in savings beyond the amount that can be absorbed by investment. It is ridiculous to maintain that debt in general must be repaid. The mere attempt to repay debts all around would involve a liquidation of assets which would result in complete economic paralysis. (Gilbert 1938, 62-63)

The authors proceed to argue against such popular notions as that public outlays are a “waste of resources,” that public debt is “unproductive,” that it “imposes a weight of interest charges” that “must eventually become intolerable,” or that public credit “is a delicate thing” that “might easily be overstrained by a long-continued increase in the public debt,” and “must inevitably lead to disastrous inflation.”

Alvin Hansen’s most extensive essay on deficit spending and the national debt – “The Growth and Role of Public Credit” – was a chapter in his 1941 book on fiscal policy, which appeared on the eve of the U.S. entry in World War II (Hansen 1941), a war that eventually caused the highest ratio of public debt/GDP in U.S. history (before or since): 125%, in 1946 (Figure 4, Chapter 2). Hansen begins by mocking “opposition to public debt,” and equates it with “the medieval opposition to interest.” (135) He proceeds with sections on the history of public debt in Britain, France and the U.S. (I), the differences between public and private debt (II), how deficit spending boosts productivity (III), the economic effects of public debt (IV). Alexander Hamilton’s views
on public debt during America’s founding in the 1790s (V), the “limits to the public debt” (VI), and the concept of “controlled borrowing” (VII).

As to the history, Hansen wants to show that the long-term trend in public debt has been upward, implying that this is the norm, and nothing to worry about. Yet the data show that public debts leveled out and then declined somewhat for about a century between the end of the Napoleonic wars (1815) and the outbreak of World War I (1915), which was also one of the most prosperous, free-market periods in world economic history; moreover, Hansen does not systematically relate the debt to state spending, credit (taxable) capacity, or national income, although he does show that in both 1818 and 1923 Britain’s national debt was twice its national income (Hansen 1941, 136). He wants to imply that high public debt ratios are not necessarily unsustainable. In fact, more recent estimates suggest that Britain’s ratio peaked at 2.6X in 1821 and 1.8X in 1923, compared to Hansen’s estimate of 2.0X (obtained from the report of a British debt commission in 1927); when Hansen wrote in 1941, Britain’s debt ratio was only 1.1X, but it would rise again during World War II, and peak at 2.4X in 1947, before gradually returning to 1.1X by 1959. Noting that public debt in the 19th century tended to grow rapidly only amid war, Hansen argues that in the 20th century it can also increase dramatically during economic contractions, amid falling tax revenues and rising relief payments; but this latter trend is by no means a bad thing, he adds, for without such automatic deficit spending (“fiscal stabilizers”), contractions would only get worse. We
should be happy that “the sphere of public finance has been enormously broadened,” Hansen writes, “owing to the political necessity imposed upon modern communities to pursue an active policy with respect to the fundamental problem of unemployment.” (Hansen 1941, 138) High joblessness is no mere brief setback, but a deeply-entrenched, “chronic,” and “fundamental problem,” justifying unprecedented deficit-spending.

Hansen also aggressively counters the long-held, classical-school analogizing between private and public debtors, and here he seems to make a valid point. Although the standard analogy counts on such commensurate elements as income-outgo, productive-versus-unproductive spending, thrift versus profligacy, and debt capacity, too often it elides the basic truth that, unlike the private creditor, the public creditor has a monopoly on the use of force, that as a state it can compel citizens to contribute tax revenues to help service public debts, can extract revenues surreptitiously by inflation, can off-load its debts to future generations, and can default on its debts, explicitly or implicitly, with relative legal impunity. This is not to say such acts are morally just or even politically expedient, but they are surely politically possible, and indeed, historically common. Hansen does not put the point quite this way, but he is aware of the great power of the modern state to borrow virtually without limit, and how this means, conveniently, for his case (in favor of deficit-spending), that concerns about public debt burdens cannot be considered on a par with concerns about private debt burdens. Private debtors can become over-extended, insolvent, and bankrupt, but
government itself runs the bankruptcy courts and cannot go “bankrupt,” nor even become insolvent, as no state “balance sheet” is audited by an independent accountant. Hansen rests his own case heavily on that made by Danish professor Jorgen Pederson, from a 1937 article (Hansen 1941, 140-144). “The analogy between the public and private economies lead to quite erroneous conclusions,” Hansen contends. “The success or failure of public policy cannot be read from the balance sheet of the public household,” he writes, “and “it cannot be determined by whether or not debt is being retired or assets accumulated.” Instead policy must be judged by the economic results it achieves.

On a less convincing note, Hansen insists that “for the state an increase of expenditures may frequently increase the total national income and improve the fiscal position of the states.” He cites Pederson that “it is quite conceivable that the reaction of public debt not only reduces the national income, but also that the fiscal position of the state may be deteriorated more by the repayment of the debt than by the incurrence of more debt.”(Hansen 1941, 144) Nor are the tax revenues required for debt service necessarily a drain on the economy. At root, writes Pederson, “the state does not obtain the power of disposal over additional funds [tax revenues], for these funds were already within the realm of its power” – that is, the modern state is presumed to “own” the wealth of its citizens – and “thus an internal loan raised by the state is not really a loan in the ordinary sense,” “there is no transfer of funds from one economic unit to another,
and no burden is shifted to future generations.” In sum, Pederson argues, “every analogy to private borrowing must be completely false.” (Hansen 1941, 142)

Hansen also contends that deficit spending can boost an economy’s productivity, in the process of embracing the tripartite public debt taxonomy of Ursula Hicks: “dead-weight debt,” “passive debt,” and “active debt.” Whereas “active debt” contributes most to productivity, by funding public capital goods, “dead-weight debt” contributes nothing to it (while passive debt has mixed effects). Dead-weight debt is usually incurred to fund war but also transfer payments, such as jobless relief amid economic contractions (Hansen 1941, 144-145). Remarkably, despite advocating aggressive deficit-spending, Hansen characterizes most outstanding public debt as a dead-weight which adds nothing to productivity; yet in so doing he consistently adheres to Keynes’s admonition that deficit-spending be reserved for public capital outlays, which are presumed to boost investment and create new wealth, instead of borrowing to redistribute existing wealth.

As to the economic effects of public debt, Hansen also is consistent in suggesting that it depends on the type of expenditures supported by the debt – with “active debt” being beneficial to the economy and “dead-weight debt” not so. The massive dead-weight debt owed by Britain after 1815 did not impede the subsequent, century-long performance of the British economy, he contends, because other factors (technology, invention) helped it grow (Hansen 1941, 152-154). As to the ultimate limits of public
debt, Hansen finds few, if any. “As long as the interest on the public debt is well within
the practical taxable capacity of the government, taking the entire business cycle into
consideration,” then “no question can arise with respect to the solvency of the
government,” and taxable capacity itself “has very flexible limits, varying, however,
with the financial integrity of the country.” (Hansen 1941, 159)

Hansen provides no specific metric to gauge a nation’s “taxable capacity,” but
makes a (somewhat circular) case for debt-financed public capital projects increasing
such capacity (168-170); he further presumes “financial integrity” derives from the
viability and profitability of the private financial sector, and that this cannot be
undermined in any obvious way by public debt itself. Indeed, Hansen contends that the
easy availability of safe, secure public bonds offsets portfolio volatility. Hansen also says
taxable capacity can be enhanced “when the government provides free services” and
whenever “some appropriate monetary expansion is justified” (170), although this seems
like pure inflationary finance, undertaken solely to support consumption, which
elsewhere he purports to oppose. The serviceability of public debt must be assessed in
relation to general prices, he adds, but he rejects “the fear [that] is frequently expressed
that an increasing public debt must eventually produce a price inflation.” In Hansen’s
view, “this conclusion is not justified.” He admits that if government borrows from the
banking system it will thereby increase the money supply, but this will not necessarily
cause price inflation, especially if money’s velocity is low and the economy is at less than full employment.(171)

Hansen is reluctant to assert that there are simply no limits at all, or ever, to public debt and its potential burdens, other than the implication that “taxable capacity” itself has limits (for the phrase itself implies a finitude). Much analysis of public debt, he says, also “implies that there are limits to public debt which, of exceeded, will tend to affect the workability of the economy,” but “these limits must be conceived of, not in terms of a fixed amount or a static situation, but in terms of a dynamic process. Account must be taken of rates of change and the magnitude of the public debt in relation to other magnitudes, especially the ratio of debt to national income.” (Hansen 1941, 174) In this regard Hansen the debt optimist begins sounding more like a realist. But as in his discussion of taxable capacity, Hansen offers no specific metric to gauge the outer limits of a safe Debt/GDP ratio. “With respect to proportionality,” he is only concerned that a large Debt/GDP ratio “may imply a disproportionate amount of wealth invested in government bonds and held by wealthy classes,” because “the rentier class might accordingly become too large at the expense of the active elements of the country.” Moreover, “diversion of a large part of the income stream into interest payments on government bonds would tend to raise the propensity to save, thus intensifying the savings-investment problem.” (174-175) In the end, he complains, “much of the discussion about the limits of the public debt is wholly unrealistic,” for “there are no
rigid and fixed limits” to such debt, and the problem “can best be taken care of by ensuring that taxation is adequate.” (175) In this way Hansen brings the analysis back to the initial question of taxable capacity – the limit of which he does not question. Also, like Keynes, Hansen sees the “rentier class” (of bondholders) not as an “active” (productive) element in the economy, but as parasitical – a class that operates “at the expense” of the active element (workers); but unlike Keynes, who sought a policy-instigated extermination (“euthanasia”) of the class, by means of near-zero interest rates, Hansen worries that it will secure too large a share of national income, and save too much; should it do so, the economy would remain underemployed and the Keynesian cure would call for more of the same, that is, more public debt, hence still more income for the non-productive class. Here one might sympathize with the socialist critique of the Keynesian debt system as simultaneously futile and self-defeating (Braverman 1956).

This dilemma may explain why Hansen feels the need to conclude his chapter by discussing what he calls “controlled borrowing,” or the ways a government might induce or compel markets and central banks to provide a low-cost demand for its debts. (Hansen 1941, 175-185) Explicit money-printing, or “crude greenback-ism,” is “no longer seriously proposed,” Hansen says, but central banks should adopt “modern greenback-ism,” whether by monetizing public debt directly or encouraging banks to do so indirectly. Lacking any concern for central bank independence, he suggests the Federal Reserve “might be required by law, at the request of the Treasury, to make interest-free
loans to the government.” (176) He denies that his ideas on public debt are politically radical; indeed, he contends, “there is a legitimate place for loan financing within appropriate limits on a continual basis” (184), even while refusing to specify the “limits,” and he insists that “the attack on chronic unemployment by means of public expenditures financed by a continually rising public debt is essentially a conservative proposal.” (181). Hansen hereby is one of the earliest advocates of what later will be called “financial repression” (examined at greater length in Chapter 6, Section 7).

Hansen altered his analytic approach to public debt capacity shift, towards greater liberality, when he found it convenient to do so, as after the U.S. entry in World War II in late 1941 (when Washington began to borrow even more than it had while fighting unemployment in the 1930s), and when he addressed businessmen. Previously he had dismissed analogies between private and public debts or analyses that presumed a national “balance sheet,” and had been unwilling to specify a safe upper limit on the ratio of public debt to national income, although he had indicated safety regarding Britain’s debt-income ratios of 200% or so in 1818 and 1923 (Hansen 1941, 136). In 1940 U.S. federal spending totaled $9 billion, 24% of which was borrowed, and the U.S. Debt/GDP ratio was 42%, up from 17% in 1930; but in 1942 U.S. spending jumped to $34 billion, nearly quadruple the level of 1940, 56% of which was borrowed, more than double the share in 1940, and the Debt/GDP ratio hit 45%, on its way to a high of 121% by 1946. In the November 1942 issue of *Fortune*, the business magazine, Hansen used the
private-public analogy and balance sheet analysis to suggest U.S. public debt could quadruple in relation to GDP, from the then-current level of 45% to “well beyond” 200%:

Public debt might be likened to the capital account of a corporation, made up, say, of long-term mortgage bonds and of one or more classes of stock. Such liabilities, it is important to remember, are offset by assets on the other side of the balance sheet. So long as these are of a character to produce sufficient earnings to meet the capital charges, including dividends on the stock, nobody would ever think of the corporation as being over-capitalized. The essential element determining the soundness of the concern is the ratio of its earning power to its capital account [and] precisely the same principle holds with respect to the public debt of a nation, of which the source of earning is usually taxation. If the power to raise revenue is in manageable ratio to the capital charges (debt service), it is proper to say that the nation is not, so to speak, over-capitalized. . . . There is little reason to fear that, with the sort of fiscal management we shall have a right to expect, the debt could not safely go well beyond double the national income if necessary. Certainly we have no occasion to think of the debt limit as being like the edge of a precipice from which we must always stay carefully away. (cited in Moulton 1943, 56 and 68)

Hansen’s last pertinent treatment of public debt is of interest, not only because it occurs in a review of two works critical of high public debt – one by a British Keynesian (James Meade), the other by an American conservative (James Buchanan), each of whom would became Nobel laureates – but because it appears in the late 1950s (Hansen 1959), by which time Britain’s debt ratio was 112%, or less than half its 1947 peak of 238%, as was the U.S. ratio of 56%, versus a 1946 peak of 121%. Moreover, in the prior decade (1949-1959) industrial production in the U.S. and Britain had increased by 67% and 33%, respectively, while jobless rates for the decade had averaged below 5%. By 1959 it seems clear that Hansen had been prescient, in 1942, to project that public debt ratios could go
“well above” 200% of national income, and safely. Britain’s peak Debt/GDP ratio of 238% (1947) was a case in point. On the other hand, by now (1959) it seemed as though Hansen’s two-decades old thesis about “secular stagnation” had been invalidated.

Meade (1958), whose specialty was trade and economic growth, not public finance, nonetheless weighed in with the argument that high public debts were “a serious and real economic burden,” due to their attendant tax burdens and disincentives to work, invest and accumulate capital, and that it was false and misleading to claim, about public debt, that we merely “owe it to ourselves,” with no harmful effects on growth. Buchanan (1958) likewise derides debt-caused barriers to growth, but insists also that private and public debt are analogous, that public debt fosters excessive government outlays, nearer-term, such that voters with “debt illusion” feel no fiscal pain, and worst of all, unfairly burdens future generations.

Hansen (1959) rejects these arguments. Meade complains that economists only stress how public debts can rise safely to levels above those previously seen or normally expected, even to unprecedented heights relative to national income, but ignores or minimizes how it also could depress the growth rate of the national income it ultimately depended upon. Meade also stresses, as Hansen had, that most public debt is a “dead-weight,” or non-productive. Hansen (1959) concedes to Meade that the public debt burdens is real, but that its import is adequately addressed by Lerner (1948), who admits that “too large a [public] debt can be a serious matter.” Even beyond Lerner, Hansen
insists, “the earlier literature,” although “designed to minimize fears of the public debt,” nevertheless does not “neglect consideration of adverse effects.” Hansen and Lerner alike, in fact, acknowledge that a fast-rising public debt can be a deadweight and sap savings, but this is a justifiable effect, because the root problem is a savings “glut.” Hansen accuses Meade of neglecting the way deficit spending serves as an “automatic stabilizer” to a volatile business cycle. “I regard this aspect of public debt as highly important,” he writes. In “highly prosperous periods” we don’t know very much about the wealth effect,” that is, whether or not more such debt makes people feel wealthier, but it has that effect amid underemployment, and in this way “becomes a powerful built-in stabilizer,” “a kind of national insurance system to which we all contribute as taxpayers, and from which we all receive the benefit of insurance against instability.” (Hansen 1959, 372) Moreover, interest payments on public debt bolster consumer demand, and precisely when it is needed most: in recessions.

Longer-term, Hansen asserts, no evidence indicates that additional public debt reduces the sum of national savings or the savings rate, although “nothing can be proved in economics,” since “there are far too many variables.” Nor is he concerned about inflation, which averaged nearly 4% p.a. from 1946 to 1958, or whether higher war debts may have triggered it; on the contrary, he is pleased that the higher post-war inflation rate “has already removed in the last 12 years well over a third of the U.S. debt burden, so-called.” (375) Thus he endorses implicit debt default by inflation – as did Keynes. Of
concern to Hansen, however, is the possibility that more public debt will, in time, boost budgetary interest expense and crowd out “much needed social welfare expenditures.”

After dispensing with Meade’s arguments, Hansen dismisses Buchanan’s arguments (Hansen 1959, 377-378), especially the notion that “public and private debts are basically alike,” for this denies the plain fact that “the national government has the power” “to issue money” and “tax all if its citizens.” “As a borrower this puts the national government in a class by itself,” says Hansen. Buchanan may oppose the extent to which the state can do such things, Hansen concedes, but he cannot reasonably deny that in fact the state can do such things, and increasingly, do them without material legal limitation, nor deny that such state powers are unavailable to private debtors. Hansen’s interpretation is accurate. No valid analogy can be made from private to public debtors, nor any valid claim that public debts might reach some inherent limit before a state goes bankrupt, nor any valid denial that, unlike private debts, public debts may be forwarded, legitimately, to future generations, without a sufficiency of matching assets, in the manner of a negative estate behest. On the positive side of the ledger, future generations usually get some benefit from the trailing outlays funded by public debt, even wartime deficit-spending, to the extent these outlays leave them politically freer than they otherwise might have been in the absence of a war. What should matter most in the debate, Hansen insists, is the real, not merely the financial impact felt by each generation, present and future. “On balance is the future generation better or worse off
by reason of the [public] debt? Probably no unequivocal answer can be give,” Hansen concludes. He also rejects Buchanan’s treatment of internal and external public debt, insisting that the former, but not the latter, can serve as an automatic economic stabilizer. And he is sure that “an increase in public debt increases the property holdings of the country – the wealth effect,” whereas “increases in private debt can have no such effect.” (Hansen 1959, 377-378).

Hansen’s main contribution to Keynesian debt theory is his argument that deficit-spending should occur (i.e., public debt should rise, unobjectionably) not merely on a short-term basis, as an automatic stabilizer to counteract cyclical shortfalls in aggregate demand, but also on a long-term basis, and if necessary also perpetually, so as to counter-act a potential “secular stagnation.” Keynes had countered the classical notion that while it was valid to incur public debts in war time, it was not legitimate to do so otherwise, indeed, that peacetime should be devoted to generating budget surpluses and repaying war-time debt, with no accumulative deficit-spending over the course of a business cycle. Keynes rejected the classical premise that there could not be equilibrium underemployment, and said that in such a case deficit-spending was justified, even over an entire cycle, albeit mainly for public investment projects, not transfers or non-productive relief payments. Hansen goes further, insisting that large public debts are warranted over many business cycles sequentially, even for relief payments, and indefinitely, if needed to forestall long-term structural stagnation.
Hansen’s basic extension implied others, too, of a kind that Keynes never addressed, such as analyses of a nation’s taxable and debt capacities. On the whole Hansen shares Keynes’s optimism about public debt: it is rarely dangerous or burdensome, and indeed can play a major role in stimulating or propping up a flagging economy; if public debt ever becomes excessive, Keynes says, it can easily and simply be reduced by official repudiation, whether explicitly (default) or implicitly (inflation), without a loss of either national solvency or sovereignty.

4.5 “Functional Finance” as a Rules-Free Approach to Public Debt: Abba Lerner

Unlike Keynes and Hansen, Abba Lerner (1903-1982) makes an overt, unabashed case for unrestrained deficit-spending, public debt issuance, and inflationary finance, under a rubric he calls “functional finance.” “In brief,” as Lerner explains it, “Functional Finance rejects completely the traditional doctrines of ‘sound finance’ and the principle of trying to balance the budget over a solar year or any other arbitrary period.” Moreover, even the “instinctive revulsion that we have to the idea of printing money, and the tendency to identify it with inflation, can be overcome.” (Lerner 1943, 41).

Lerner’s economic and public finance theories were warmly embraced by the more radical, socialist-leaning Keynesians of the 1940s, but his influence waned during the more conservative 1950s. In the 1970s, after the international gold-exchange standard was abandoned (in 1971), inflation jumped, and deficits seemed to become more chronic, vestiges of his radical vision were suspected to have contributed to the puzzle of
“stagflation” (the simultaneity of high rates of inflation and joblessness). Lerner’s ideas then seemed to disappear in the 1980s and 1990s, amid the rise of supply-side policies and the collapse of centrally-planned regimes. Yet the revival of Keynesian policies surrounding the financial crises of 2008-2009 seems to entail policymakers’ adopting, whether knowingly or not, Lerner’s rule-free policy approach, as finance ministers and central bankers alike jettison nearly every traditional mode of public finance and undertake vast, unprecedented policies to bail out and revive economies, by any and all means necessary, including by massive rates of deficit-spending, vast new debt issuance, near-zero interest rates (for indefinite periods), and substantial, new paper money-creation (aka, “quantitative easing”).

A young Lerner emigrated from Romania to Britain and by 1929, at age 26, was enrolled at the London School of Economics; he came in contact with Keynes during a stay at Cambridge (1934-1935), just before Keynes published his General Theory. Soon thereafter Lerner emigrated from Britain to the U.S. His academic career was spent at various schools, including Columbia, Amherst, the New School for Social Research, and Berkeley. In his most famous work, The Economics of Control (1947), he sought to steer a policy path between full capitalism and full socialism, both of which he dismissed as dogmatic. Lerner’s preference was for utilitarian-guided policy-making; by assuming a diminishing marginal utility of income and wealth, and seeking to maximize total social utility, Lerner called for policies to engender a perfect equality of wealth and income.
Near the end of his life he declared that Keynes was far too timid in his policy advice, for “he did not carry his conclusions all the way.” (Lerner 1978). If true, Lerner is perhaps the most logically consistent Keynesian to have appeared since 1936, an interpretation also offered by Colander (1984). Yet if so, this does not necessarily mean Lerner’s ideas reside beyond mainstream economic teaching. According to Colander, “what eventually became known as textbook Keynesian policies were in many ways Lerner’s interpretations of Keynes’s policies.” (Colander 1984, 1573).

For Lerner, deficit-spending (indeed every public finance device) is to be justified solely by its actual economic effects and, above all, by whether it promotes “the public interest” or “social interest.” Fiscal-monetary measures need never be justified (or condemned) by pre-determined standards or rules – whether the classical budget-balance rule, or the rule that favors running surpluses in peacetime, or the rule that public debt should only support public spending on productive capital goods, not consumptive goods or transfers, or the rule that public debts are advisable on cyclically but not secularly, or the rule that public debt should never be deliberately repudiated, or the rule that it should not be monetized and inflated away by a central bank.

For Lerner any and all such rules might or might not be followed, might be deployed in some cases but not in others, might be deployed only temporarily, or never, and yet with complete moral, legal, and political impunity. Public financial policy, however it may be construed or applied, should guarantee only three things: a level of
aggregate demand that achieves a jobless rate of 3% or less; a low inflation rate; and a rate of interest that is consistent with an optimum volume of investment (to achieve full employment). The state should spend and tax, borrow and repay, issue and rescind paper money, for the sole purpose of achieving these three ends, simultaneously and indefinitely, for no other reasons whatever. For Lerner the aim of public finance is not to raise or disburse funds to support any activities of a circumscribed state other than those required to maintain aggregate demand and full employment, in all circumstances; instead of “traditional finance,” nations should only practice “functional finance.”

The central idea [of Functional Finance] is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the results of these actions on the economy and not to any established traditional doctrine about what is sound and what is unsound. This principle of judging only by effects has been applied in many other fields of human activity, where it is known as the method of science opposed to scholasticism. The principle of judging fiscal measures by the way they work or function in the economy we may call Functional Finance. The first financial responsibility of the government (since nobody else can undertake that responsibility) is to keep the total rate of spending in the country on goods and services neither greater or less than that rate which at the current prices would buy all the goods that it is possible to produce. If total spending is allowed to go above this there will be inflation, and if it is allowed to go below it there will be unemployment. . . . The second law of Functional Finance is that the government should borrow money only if it is desirable that the public should have less money and more government bonds [and] conversely, the government should lend money (or repay some of its debt) only if it is desirable to increase the money or to reduce the quantity of government bonds in the hands of the public [in each case, as a means of optimizing interest rates]. (Lerner 1943, 39-40).
As to public debt, Lerner endorses those arguments, made by optimistic predecessors, that it is never akin to private debt, that internal public debt is no burden, and that public debt never even burdens posterity:

By far the most common concern about the national debt comes from considering it as exactly the same kind of thing as a private debt which one individual owes to others. . . . The simple transferability of this rule to national debt is denied by nearly all economists. . . . One of the most effective ways of clearing up this most serious of all semantic confusions is to point out that private debt differs from national debt in being external. It is owed by one person to others. That is what makes it burdensome. Because it is interpersonal the proper analogy is not to national debt but to international debt. . . . But this does not hold for national debt which is owed by the nation to citizens of the same nation. There is no external creditor. “We owe it to ourselves.” . . . A variant of the false analogy is the declaration that national debt puts an unfair burden on our children, who are thereby made to pay for our extravagances. Very few economists need to be reminded that if our children or grandchildren repay some of the national debt these payments will be made to our children and grandchildren and to nobody else. (Lerner 1948, 255-256)

In his presentation of “functional finance” in The Economics of Control (1947, 302-322), Lerner tells readers that only a nation’s externally-owed public debts are burdensome, those which, unlike internal debts, “indicate impoverishment of the borrowing country and enrichment of the lending country. Of this kind of debt the popular criticism is warranted.” (305) A country, he says “cannot by monetary manipulations consume more than it can produce,” and an internal debt “does not really give the country anything that it did not have to begin with,” so a repayment of principal and interest “does not take away anything from the country as a whole.” Unlike internal public debts, external public debts “should be limited because the
repayment will constitute a real burden,” and “there may great inconvenience which could lead to default.”(305) Otherwise, there should be no cause for concern about a nation’s domestic debt; indeed, the “size of [internal] debt is a matter of almost no significance beside the importance of maintaining full employment.” (303)

For Lerner, the national debt is not a burden on posterity because if posterity pays the debt it will be paying it to the same posterity that will be alive at the time when payment is made. That national debt is not a burden on the nation because every cent in interest or repayment that is collected from the citizens as taxpayers to meet the debt services is received by the citizens and government bondholders.” (303) Lerner stresses how “the national debt is not a sign of national poverty,” any more than a bond certificate constitutes national wealth, and “just as increasing the national debt does not make the nation poorer, so repaying the national debt does not make the nation richer.”(303) Must a national debt ever be repaid, in whole or in part? No, “any more than it is true that all banks must call in those debts and repay their depositors on some catastrophic day.” Individual public bondholders, to be sure, must repaid, but others who purchase (or redeem) their holdings now stand in the seller’s place.

In a still more radical, but strictly logical vein, Lerner denies that an internal public debt of any magnitude can burden society; since “we owe it to ourselves,” when we owe more, we also own more, and as such there is no decline in society’s net worth. Every public debt security, by definition, has an asset and liability aspect, as mirror
images, one necessarily offsetting the other. Government bonds are not “net wealth,”
but neither are they “net liabilities;” their value rests entirely in their functional capacity,
their power, when funding a government-spending multiplier, to boost demand. Going
beyond Keynes and Hansen, Lerner argues that there is no effective limit to the height of
public debt or associated interest expense; neither can be “too much,” and regardless of
how large they might become, even in relation to national income, or taxable capacity,
they can still never entail a burden to society as whole. In a pinch, even if public debt
should ever seem unserviceable, the state can simply print money:

[If] the result [of Functional Finance is] a continually increasing national debt . . .
[at] this point two things should be made clear: first, that the possibility
[presents] no danger to society, no matter what imagined heights the national
debt might reach, so long as Functional Finance maintains the proper level of
total demand for current output; and second (though this is much less
important), that there is an automatic tendency for the budget to be balanced in
the long run as a result of the application of Functional Finance, even if there is
no place for the principle of balancing the budget. No matter how much interest
has to be paid on the debt, taxation must not be applied unless it is necessary to
keep spending down to prevent inflation. The interest can be paid by borrowing
still more. As long as the public is willing to keep on lending to the government
there is no difficulty, no matter how many zeros are added to the national debt. If
the public becomes reluctant to keep on lending, it must either hoard the money
or spend it. If the public hoards, the government can print the money to meet its
interest and other obligations, and the only effect is that the public holds
government currency instead of government bonds and the government is saved
the trouble of making interest payments. (Lerner 1943, 42-43). The absolute size
of the national debt does not matter at all [and] however large the interest
payments that have to be made, these do not constitute any burden upon society
as a whole. (Lerner 1943, 47)
The radical nature of Lerner’s approach to public debt and inflation is obvious—and yet today many such policies are now considered part of the “new normal,” as practiced in Japan since 1990 and by major western governments since the onset of the financial crisis of 2008-2009. Keynesian and Nobel laureate Paul Krugman (2011, 2012) is one of today’s more avid proponents of Lerner-style policies, making the case against any rules or norms whatsoever, and for unlimited fiscal-monetary policy discretion.

Just as Lerner feels that Keynes did not go far enough in his policy prescriptions— that is, did not advise still more deficit-spending, socialization of investment, redistribution, and inflation—so he feels that Hansen’s analyses and preferred policies were too moderate, and insufficiently respectful of functional finance. “[E]ither this [approach] was not seen clearly or it was considered too shocking or too logical to be told to the public,” writes Lerner. “Instead it was argued, for example by Alvin Hansen, that as long as there was a reasonable ratio between national income and debt, the interest payment on the national debt can easily come from taxes paid out of the increased national income created by deficit financing.” (Lerner 1943, 43)

For Lerner “this unnecessary ‘appeasement’ opened the way to an extremely effective opposition to Functional Finance. Even men who have a clear understanding of it,” who know an internal public debt is no real burden, nevertheless “have come out strongly against ‘deficit spending.’” (Lerner 1943, 43) In Lerner’s view, Keynes is wrong to distinguish good from bad investment aims, good from bad forms of public debt, or
good from bad inflation, just as Hansen is wrong to seek specific criteria for gauging how much public debt or interest expense a nation may safely incur. For Lerner, the answer is: there are no limits to speak of, and to suggest otherwise is to unduly handcuff policymakers, to impede or preclude them from pursuing the only goal worth achieving: the maintenance of sufficient aggregate demand and full employment. As long as this goal is attained, all will be well with a nation’s finances.

Indeed, Lerner contends, with full confidence in the power of the Keynesian spending multiplier (implying that it exceeds three), that “spending by the government increases the real national income of goods and services by several times the amount spent by the government” (Lerner, 1943, 46), and as such, a point arises when deficit spending is no longer needed, having done its job. “As the national debt increases,” he explains, “it acts as a self-equilibrating force, gradually diminishing the further need for its growth and finally reaching an equilibrium level where its tendency to grow comes completely to an end.” The next result seems paradoxical, but as Lerner elaborates, “the greater the national debt, the greater is the quantity of private wealth.” We owe it to ourselves, he has said, and if so, we also own it by ourselves, so the more of it (public debt) which is created, the richer a nation must become. Thus, for Lerner, “the greater the private fortunes the less is the incentive to add to them by saving out of current income,” and as savings are curbed, spending (aggregate demand) increases, which boosts the overall economy. (Lerner 1943, 49) No additional public debt is required, at
least for the moment (until aggregate demand once again becomes deficient). Instead of
the claim, made later by a socialist critic of the Keynesian approach (Braverman 1956),
that an ever-larger public debt is self-defeating because it only further enriches the
financial class, at the expense of the laboring class, Lerner foresees a harmonious result
from a debt policy that adheres to the guideposts of functional finance.

A final aspect of Lerner’s theory of public finance is worth noting, because it
implies a policy stance friendlier to the possibility of a free, prosperous economy than
most Keynesians might intend. Lerner is concerned, we have seen, with the effects of
public financial policies on the economy, for good or ill, not with their effects on public
finances; thus he is unwilling to have policymakers sacrificing the stability, strength, or
prosperity of the private economy to the alleged benefit and financial integrity of
government. In contrast, many policymakers sympathetic to free markets and “sound
public finance” have, on many occasions, willingly sacrificed the strength of the private
economy, whether by severe interest-rate hikes (to curb investment “speculation”) or by
severe tax hikes (to fix unbalanced budgets), as was done under the Hoover
Administration in the U.S. (1928-1932).

Lerner’s preference for public debt finance is also relevant; unlike taxes, which
are compulsory, public debt securities are investments with direct returns that are
purchased voluntarily, typically by the wealthy. For pro-capitalist economists to oppose
public debt financing, on the grounds that they are defending “sound finance” and
“sound money,” without also insisting on less state spending, is effectively to demand higher taxes or inflation. Of course, Lerner is not a pro-capitalist, but under “functional finance” he privileges the financial strength of the private sector, not that of the state, whereas pro-capitalist economists preoccupied with budget balance are inclined, ironically, to sacrifice the good of private wealth to the good of state finances.

4.6 Keynesian Debt Theory Matures: Harris, Samuelson, and Musgrave

In a rare case of an entire volume devoted to the Keynesian theory of public debt, in 1947 Harvard professor Seymour Harris (1897-1974) published *National Debt and the New Economics*. Harris, who also served in government and later advised the Kennedy Administration in the early 1960s, wrote or edited more than forty volumes while teaching at Harvard for forty-one years (1922-1964), overlapping with Hansen between 1937 and 1957. Taking a more comprehensive and balanced approach, compared to the previous treatments of Hansen and Lerner, Harris presents public debt theory and evidence in a manner that more closely reflects what Keynes believed about deficit-spending and public debt, and what he might have written, given the time and inclination to do so.

Compared to Hansen and Lerner, Harris’s 1947 book is balanced, much like a textbook, as it includes and cites more varied opinion and interpretation on the private-public debt analogy, the burden of debt, the relation of income and taxable capacity to debt, the possibility deficit spending can ensure full employment, and the question of
whether posterity is affected (or not) by public debt. Yet there is no discussion of Hansen’s “secular stagnation” thesis from the late-1930s, nor of his accompanying case for perpetual deficit-spending and debt build-up, to fight it. Harris also finds no value in the open-ended, free-wheeling, deficit-spending methods and inflationary biases embedded in Lerner’s “functional finance,” even though it too had appeared just a few years earlier. Indeed, Harris tries heartily to bridge what appears to some to be an unbridgeable gap between the old and new economics, at least regarding fiscal policy; he is reluctant to jettison the entirety of orthodox “sound finance,” but concurs with Keynes that orthodoxy failed utterly to respond to (or cure) the 1930s depression – and that it only raised tariff and tax rates, making economic conditions even worse.

According to Harris, context is crucial, such that “the rise of [public] debt cannot be considered irrespective of national income.” (78) The U.S. national debt could become troublesome, if excessive, such as when fiscal policy undermines economic growth and full employment, or fails to bolster either when they flag. “Our national debt of approximately $260 billion is dangerous,” he remarks – then near its peak, at 121% of GDP, due to World War II spending – but “only if it is not well-managed.” (276) Although public debt certainly “affects the volume of output and income,” which is the ultimate source of debt service, “it is easy to exaggerate the importance of financial arrangements” and expect deficit-spending alone somehow to pay its own way. (276) “On balance” it is possible “public debt may well be a burden,” even internally-held
debt, but “there are important offsets” – more liquid assets, more capital assets and national income, lower interest rates, the weight of competing government spending requirements – and if these change in material magnitude or direction, so also can the public debt burden (276) The burden and its context must not be ignored. “When [aggregate] demand is deficient,” Harris says, “the government’s task is to subsidize demand,” and in such a context “debt repayment is out of the question, and the presumption is in favor of debt growth.”(277) Yet it is also “conceivable that full employment may be attained without recourse to government financing,” but “not without significant institutional changes,” including anti-trust action, lower trade barriers, and more flexible prices and wage rates.(101)

In the following year, after the re-election of President Truman, Harris wrote brief remarks for the *Harvard Crimson*, seeing it as a vindication of Keynesian policies, but also conveying a certain conservatism about the principles of public debt. “The essence of Keynesianism,” he wrote, is that government must “guarantee a minimum of demand and a relatively stable demand” so as to achieve “a prosperous economy,” and although the best way of “ballasting the economy in depression and deflation is not the Hoover policy of economy, but the Roosevelt policy of deficit financing,” “that does not mean a steady accumulation of public debt or continued inflation.” “The way to deal with inflation is to reduce the amount of money,” not to raise tax rates. Keynesian prescriptions did not fail in the 1930s, because in fact they were never truly tried.
“Unfortunately, in Roosevelt’s day, the correct theory of fiscal policy had not quite jelled,” Harris writes, and “even Roosevelt could not overcome his nurtured fear of debt,” nor did his party “introduce an adequate policy of tax reduction in the thirties.” But now, in a post-war setting, with Keynesian war-time financial schemes vindicated, “this is the time of pay off debt: this country should pay off $10 billion of debt [4% of total debt] in the next year.”(Harris 1948) This is an example of the judicious balance Harris provided throughout his 1947 book on public debt. Harris is one of the few Keynesians who may be fairly characterized as a realist on public credit and debt.

Two other Keynesians economists, prominent largely in the 20th century, yet who today still exert an important, trailing influence on students, policymakers and journalists alike, because of the textbooks they wrote and the millions of students they taught and influenced, are Richard Musgrave (1910-2007), famous for his textbook, The Theory of Public Finance (1959), and Nobel laureate Paul Samuelson (1915-2009), famous for twelve editions of his widely-used college textbook, Economics (1948-1985). As to the theory (and practice) of public debt, each generally captures what we may characterize as the “mainstream” position, though solely within Keynesianism – neither overtly Lerner nor overtly Harris. We devote no more space to their work, not because it is not influential, but because it mainly popularizes (in textbooks) the work of other theorists.

Keynesian theories of public debt, which have proved nearly the opposite of those propounded by the classical and neo-classical economists, and which characterize
budget deficits and public debts as beneficial, did not arise spontaneously, out of context, but in the wake of a multi-decade trend of political-economic ideas favoring populism-progressivism; such ideas led, in the U.S., to a new federal income tax, central banking, wider suffrage, and, amid WWI, an end to the classical gold-coin standard and a large accumulation of war-related public debt. The ideological trend favored a more expansive role for the state, and Keynesian theory sanctioned this role.

4.7 Keynesian Debt Theory With a Crucial Assist From Easy Money

We have already seen how Keynes was keen to identify and endorse monetary debasement and inflation as means of deceptively dismissing real public debt burdens. Crucial to the institutionalization of Keynesian principles and policies was the proliferation of new central banks in the progressive decades surrounding the turn of the 20th century, beyond the Swedish Riksbank (1668), Bank of England (1694), and Bank of France (1800). New progressive-era central banks included the Bank of Germany (1870), Bank of Japan (1884), Bank of Italy (1893), Federal Reserve (1913), Reserve Bank of Australia (1920), and Bank of Canada (1935). These banks were founded not to correct “market failures” but to assist fast-expanding governments and welfare states in the underwriting and distribution of the vast new public debts resulting from deficit-spending. The “organization of debt into currency,” already seen in private banking, now extended to the use of public debt as backing for state money monopolies.
The first third of the 20th century saw a radical displacement of what had been a largely free-market system of money and banking, regulated by the automaticity of the gold standard, with nationalistic and monopolistic central banks issuing fiat paper money with the aim of assisting client states with their financing needs. The new state-centric monetary system embodied a plank in Marx and Engels' *Communist Manifesto* (1848): “Centralization of credit in the hands of the state, by means of a national bank with state capital and an exclusive monopoly.” The power of legally-privileged central banks to monetize public debt, unrestrained by the gold standard, facilitated a vast new issuance of public debt, adding a new dimension to public debt theory and practice. Not coincidentally, this vast expansion of the state’s role in the economy, and in its power to deficit-spend and inflate, accompanied new extensions of democracy and the franchise.

Three other significant developments in the first third of the 20th century helped facilitate the subsequent, Keynesian case for public deficit-spending, not as a passive result of revenue shortfalls amid economic slowdowns, but as an active, deliberate policy, on principle and in full: World War I, the Allies’ demand for war reparations from the Central Powers (mostly Germany), and the Great Depression. The war entailed a massive increase in public debts worldwide; reparations, which Keynes adamantly opposed in his first book (1920), fostered discussion about sovereign debt burdens; the Great Depression, which led to huge deficits, also facilitated the Keynesian theory that
deficit-spending could supplement aggregate demand, cure the depression, and bring
an economic recovery.

Keynes argued that government deficit-spending could supplement national
income and stimulate the economy, through a “multiplier” effect unique to public
spending, even if that spending was frivolous or wasteful. Optimal results were
achievable amid the under-employment or less-than-full utilization of economic
capacity. The theory denied that public debt “crowded out” private borrowing, because
under-employment also meant under-borrowing, indeed, money-hoarding. In the event
new public debt supplies cause an increase in interest rates, and thus preclude an
investment recovery, central banks should simply monetize the additional debt and
keep interest rates low, indeed, near zero if needed, so as to “euthanize” public
bondholders. If it happens that central banks cannot easily accomplish this public debt
monetization due to the strictures of the gold-bullion standard, those strictures should
be loosened, according to Keynes, or abandoned entirely. In his more philosophical
essays, we have seen, Keynes clearly disdains both the gold standard and free-market
capitalism, blaming each for the horrors of the Great Depression. Seeing the deflation
during the depression, Keynes called for currency devaluation and re-inflation.

Although Keynes had been uncomfortable with the idea of chronic deficit-
spending, in good times as well as bad, whether the economy was merely slowing, in
recession, or in a depression, his successors – primarily Lerner and Hanson, not so much
Harris and Musgrave – argued for a perpetual resort to deficit-spending and even inflationary finance, whether in the spirit of fighting Hansen’s “secular stagnation” or adopting Lerner’s “functional finance.” Free market policies and orthodox budget balancing, it was argued, should no more apply in normal times than in depression years. Perpetual deficit-spending and the steady accumulation of public debt has been justified, even since 1936, whenever aggregate demand is said to fall short of aggregate supply, which usually means whenever the jobless rate rises above 5% or so (even if for purely microeconomic reasons). The classical economists had said aggregate demand and aggregate supply were necessarily equal – two sides of the same coin; unemployment was due to faulty price adjustment impeded by legal restrictions and remediable by lower wage rates. Keynes and Keynesians alike rejected this logic, and in so doing, sought to justify deficit-spending.

On the burden of public debt, an issue which became all the more important given record-high levels of public debt in the aftermath of WWI, the Great Depression, WWII, and due to an increased acceptance of the principles of “functional finance,” it was argued, by most Keynesians, that only foreign debts were truly burdensome, as their servicing sent domestic funds abroad; but domestic public debt was deemed no burden because “we owe it to ourselves,” according to Lerner. Since only foreign (“external”) debts were deemed a deduction from national wealth, Keynesians also said such debt could (and should) be repudiated opportunistically, or restructured on more
favorable terms (to public debtors), especially after the end of the gold-exchange standard and the world-wide, multi-national shift to fiat money, as occurred in 1971. Thereafter, as long as a sovereign borrowed in its own currency, and avoided the “original sin” of borrowing in others’ currency (which it could not print at will), it would enjoy an “exorbitant privilege” in international capital markets (see Chapter 6, Section 4). A sovereign that borrowed in its own money could avoid defaulting on its debts suddenly and explicitly, but still do so gradually and implicitly, by inflation.

Critics of Lerner’s approach to public debt ask how a potentially-infinite build-up of such debt can prove so innocuous; disaggregating the creditor-debtor nexus, they try to show that asymmetric burdens can trigger systematic instability. But in the 1950s, 1960s and even the 1970s, the general impression remained, among mainstream (by now Keynesian) economists that public debt was benign, indeed, as the Dean of Dartmouth’s business school described it, in the mid-1950s, was a lubricant for the economy. “What then is the real problem of debt?,” he asked. “It is one of maintaining a fair proportion between the incomes of those who incur debt and the total amount of their debts. It is one of maintaining reasonable liquidity.” “Debts are another case of ‘duplicit’ in economics. The debt per se may seem undesirable – and when it exceeds our ability to expand, it actually is undesirable. But when used wisely, debt can spur production and employment. That is wholly desirable.” (Upgren 1955, 62) Forty years later, in 1995, two Keynesians, even while conceding that Keynesian theory was no longer the prevailing
orthodoxy, nevertheless insisted it should be, and that then-current debt levels were safe: “We do not think that the present political orthodoxy which states that the budget should be balanced – whether now or sometime in the future – has any merit. So long as the government does useful things, the U.S. budget deficit can continue at present levels pretty much indefinitely (Galbraith and Darity 1995). Fourteen years later, amid the Great Recession and fast-rising public debt, one of these authors attributed the financial meltdown to budget deficits caused by tax cuts in 2003, to “the predator state,” and to the abandonment of free market policies, which, nonetheless, he endorsed. (Galbraith 2009)

The “new economics” of Keynesianism took hold in Britain during and after WWII, and then in the U.S., as early as the Employment Act of 1946 (which created the President’s Council of Economic Advisors), but then further with Professor Samuelson’s first Keynesian textbook (published in 1948), and by formal political adoption through the Democratic Party, starting in the 1960s. This was the “fiscal revolution” in America that made for chronic deficit spending and a steadily-rising ratio of public debt to GDP (Stein 1969). In this revolution public debt was seen as wholly beneficial to the economy, and in the process, deficit-spending made possible a further expansion of the welfare state, even amid war (Viet Nam), through “Great Society” programs (Medicare and Medicaid). These are now some of the biggest components of federal spending – and more than ever contribute to a rising U.S. public debt.
The Keynesian case for inflationary finance, through debt monetization by central banks, effectively was institutionalized in the 1970s, especially after the termination of any last tie of global currencies to gold, with the abandonment of the Bretton Woods gold-exchange standard in 1971. No longer, anywhere in the world, did there exist a genuinely credible commitment to repaying public debts in the form of truly reliable money. For the first time since 1945 central bank balance sheets expanded enormously, starting in the 1970s, and to an ever larger extent later, in 2008-2012 (by a policy that came to be called “quantitative easing”). As explained further, in Chapter 6, this balance sheet expansion led to charges of “financial repression,” whereby government fiscal-monetary policy mandates or induces debt holdings and keeps public debt yields inordinately and artificially low.

4.8 Demand-Side and Supply-Side on the Same Side

That Keynesian economics in the 20th century constituted a genuine “fiscal revolution,” with permanent and lasting effects worldwide, is perhaps best corroborated by the set of policies that followed its peak dominance in the 1970s, policies based on an intended revival of Classical economic principles, even while ignoring its orthodox public finance prescriptions – *viz.*, “supply-side economics” and the “New Classical macroeconomics.” Even these rival theories and policy systems condoned (but did not explicitly advocate) the generation of large budget deficits, albeit not on the grounds that deficits (or attendant public debts) “stimulated” the economy, *per se*. Instead tax-
rate cuts were seen as preferable, even if spending could not be restrained, and that, unlike the imposition of taxes, at least public debt is purchased voluntary. Moreover, with a stronger dollar, supply-side policy could attract more foreign buyers of additional public debt (like China) – albeit precisely the type of public debt (external) that Keynesians viewed as truly burdensome (unlike domestically-held debt). Public debt debate in the 1980s explored the reasons for high real interest rates, and whether these were caused by wider budget deficits (through the phenomenon of “crowding out”). Yet interest rates on public debt also declined steadily during that decade, leading some advocates of supply-side economics to content that “budget deficits don’t matter.”

Although no prominent supply-side economists explicitly advocate deficits in the Keynesian fashion – viz, aggressive spending to stimulate investment, stabilize the cycle and supplement aggregate demand – nor do they believe tax-rate cuts can “pay for themselves,” in full (although critics claim they do). As such, supply-siders necessarily concede that budget deficits may well arise, amid tax-rate cuts, and indeed argue that deficits should be acceptable if spending is not to be cut and if the only other means of achieving budget balance is by an economy-harming tax hike, as in America under President Herbert Hoover in the early 1930s. At most, supply-siders are reluctant apologists for what are passively-generated budget deficits. Although they debate whether or not budget deficits “crowd out” private investment, raise real interest rates, or cause less-rapid growth in government spending (“starve-the-beast”), they do not
contend that budget deficits or public debts help the economy or financial sector. Deficits and debts are neither necessarily harmful or beneficial; it depends on circumstances. Thus supply-side economists are best classified, on deficits and debt, not as pessimists or optimists, but as realists, in the tradition of Alexander Hamilton.

Keynesians, of course, have known that in tax policy the Laffer Curve has been influential, since the early 1980s, in supply-side arguments saying that tax rates might be so high as to undermine national income, and to generate less-than-optimal tax revenues, thus that tax-rate cuts may might boost income and tax revenues, at least to some extent. Keynesians, despite being skeptical of the claim, have developed what they term the “Laffer Debt Curve,” which purports to demonstrate the existence, not of an optimal rate of tax, but an optimal level of public debt. (Claessens 1990, Husain 1997, Agénor and Aizenman 2005). Yet for the most part the large deficits of the 1980s caused consternation among Keynesians, especially those who wished not to endorse supply-side policies, yet still favored deficit-spending, and yet also could not deny, at least openly, that the 1980s seemed more prosperous relative to the stagflation of the 1970s. Nobel laureate and Yale professor James Tobin, writing in 1965, had dismissed the public choice theories of Buchanan, on public debt, on the grounds that “the political theory is questionable, and so is the economics.” (Tobin 1965, 680). Yet two decades later, in the midst of “Reaganomics” and a growing acceptance of public choice insights, Tobin would argue that “U.S. fiscal policy,” in fact, “was quite conservative from World
War II to 1981” and that the U.S. faced “not an apocalyptic day of reckoning” in 1985, “but the old story of crowding out of productive investment.” (Tobin 1985, 12). For Tobin, “crowding out” was impossible amid the vast unemployment of the 1930s, but occurred in the 1980s, amid more fully-employed resources, even though, in his view, supply-side policies failed.

Politically, it seems obvious that in recent decades supply-side theorists and policy advisors have proven useful precisely to those center-right politicians who want to keep government spending elevated and tax rates either flat or down; but likewise, Keynesian theorists and policy advisors have proven most useful precisely to those center-left politicians who wish to raise both the rate of spending and rates of taxation (especially on the rich). Combined, these politicians represent the relevant electoral spectrum; yet because all share a rational reluctance to commit career suicide by advocating restraint in government spending, they also may ensure, perhaps for decades to come, unending deficit-spending and a perpetual accumulation of onerous public debt, not only in absolute terms, but versus GDP, not only in war but also in peace, and not only in bad economic times but good. That both ends of the political-economic spectrum have come to condone, if not actively endorse, chronic deficit-spending, may reflect motives inherent in any unlimited democracy; the outcome understandably appeals to and pleases that majority of voters who are excused fromshouldering the full cost burden of an enlarged state, while also obtaining its benefits.
That Keynesian public debt theory made for a permanent fiscal revolution over the past eight decades seems clear from its suspiciously hasty revival amid the financial crises of 2008-2009, despite its prior eclipse in the 1980s and 1990s. Remarkably, the revival of Keynesian policies entail policymakers’ adopting not the policy advice of the more reserved Keynesians, but the rules-free, discretionary policy approach of Abba Lerner. Finance ministers and central bankers in recent years have abandoning most of the remaining (and already previously-loosened) rules and modes of public finance, in pushing for massive rates of deficit-spending, vast new public debt issuance, perpetual (and near-zero) interest rates, and stupendous sums of new money-creation (aka, “quantitative easing”). Keynes in the 1930s had sought to bridge the gap then existing between classical debt policies and those he preferred, but with limited success. Yet in the early twenty-first century, it seems the developed world is enacting Keynes’s policies in their most expansive logically-consistent (i.e., Lernerian) form. The Keynesians’ dramatic rise (1940s, 1950s, 1960s), fall (1970s, 1980s, 1990s), and revival (recently) contrasts with the steady ascendance of the Public Choice school, with its insights into the political origins of public debt, and into the seemingly unmitigated growth of public debt in a democratic age. It is to Public Choice’s public debt theory that we turn next.
5. Public Choice and Public Credit

The public choice school of thought, as it pertains to public finance in general and public debt in particular, is developed primarily in the works of 1986 Nobel laureate James Buchanan (1919 - ), Richard Wagner (1941 - ), and Geoffrey Brennan (1944 - ). Unlike classical and Keynesian approaches, which focus mainly on the economic consequences of deficits and debt, public choice draws heavily on political economy; it seeks to analyze and explain the interaction between political and economic activity, and especially the institutional settings and motives that determine the extent of deficit-spending and public debt. Public choice theorists pay more attention to politics, which is obviously relevant to a treatment of sovereign borrowing, and focus more on the origins than the consequences of budget deficits and public debt, although the effects of each are not irrelevant to discerning root causes. For example, if public debt is viewed as a viable means of “stabilizing” the business cycle or “stimulating” a “demand-driven” (Keynesian) economy, there may be greater political will (or less reluctance) to incur it, versus a context in which it is viewed as harmful to the economy or unfair to posterity.

After the world’s financial system seized-up in the fall of 2008, a long and deep “Great Recession” ensued, as did a perhaps-surprising resurgence of Keynesian policy prescriptions (see Davidson 2009, Skidelsky 2009, and Bateman et al 2010), which condoned vast new sums of deficit-spending. In only a few subsequent years, the governments of major industrialized nations had incurred more public debt, in

Buchanan’s book and his subsequent work in public choice contributed in no small way to an eventual diminution in the dominance of Keynesian economics in academia, journalism and policymaking, although other factors were relevant, such as the spread of monetarism, the rise of the “new classical” economics, and an empirical economic record, in the 1960s and 1970s, that proved none-too-kind to the reputation and Keynesian economics and the claims of its practitioners.

For at least two decades, until the late 1990s, it seemed the Keynesian approach would be eclipsed indefinitely; supply-side policies, adopted globally, brought a revival of economic growth and productivity, a simultaneous decline in jobless rates and inflation rates (the reverse of the 1970s “stagflation”), a less-volatile business cycle, budgets in balance or surplus, and for many countries public debts declining as a share of GDP. Yet in recent years Keynesian precepts and policies have again challenged the classical, supply-side approach, albeit now supplemented (and mitigated) somewhat by the public choice insights of James Buchanan *et al.* Again large questions are being asked. Does public debt ensure economic salvation or instead foretell national financial ruin? Is public debt neither beneficial nor harmful, but merely innocuous? Which of these views might prevail in the coming years, and how might they influence policy?
5.1 The Essence of Public Choice

The public choice approach is distinctive, not only because it rejects any sharp line between the political and economic realms, even in freer societies, but also because it rejects the dualism inherent in the standard assumption that economic actors are malevolently egoistic while political actors, in contrast, are benevolently altruistic and public-spirited. Public choice unifies the assumption: both types of actors, each in their respective realms, are assumed to be self-interested, but whereas economic actors focus on producing income and accumulating wealth, political actors focus primarily on amassing power and exerting influence. Methodologically, public choice effectively imports into political science some key premises and techniques of economics, such as rational choice, exchange, maximization, and equilibrium.

The positive aspect of public choice theory, in contrast to its normative aspect, takes its root premise – about the ubiquity of self-interested utility maximization – not as ethically advisable but as plainly factual. Yet positive public choice analysis does not presume that self-interest is atomistic or solipsistic, in the sense of not feeling some personal utility from the value that inheres in certain others. Public choice seeks to embrace realism instead of idealism, and by referencing a root motive, held to be universal, in all realms, it likewise tries to offer a more consistent theory of political economy. While public choice scholars tend to view the political idealists as unrealistic and naïve about human motives, the political idealists, in turn, will view public choice
scholars as unrealistic and cynical about such motives. Moreover, public debt theory in
public choice analysis is not devoid of normative content; indeed, Buchanan (1985) has
expounded on what he calls “the moral dimension of debt financing.”

Public choice scholars rightly criticize those idealists who imagine some Platonic
“perfection” in a supposedly “pure” market economy, who denounce its pre-judged
shortcomings (“market failures”) relative to some avowedly unreal standard, and who
then seek to “fix” them by the forceful intervention of supposedly benevolent, selfless
political actors who advance not their own special interests but the “public interest,”
“common good,” or “general welfare.” The public choice realist contends, in contrast,
that all actors, regardless of the social realm they occupy, pursue their self-interest, seek
to satisfy their preferences, and try to maximize their utility, and if so, then “government
failures” are at least no less likely than are “market failures.” Only a proper institutional
framework – one comprised of rationally chosen norms, rules, laws, and constitutions –
can ensure optimal domains for political and economic activity, and a mutual harmony.
The public choice approach posits that it is unwise to bifurcate these two realms, and
offers a more individualistic perspective (not only politically, but methodologically), as
it generally rejects the Germanic-organic view of the state as comprised of essentially
inseparable and right-less subjects, viewing citizens instead as distinct, valued beings.

Perhaps the main defect of public choice, in this regard, is its implicit denial that
the ideas and attitudes which generate public fiscal profligacy will not also influence the
choice of whether to adopt or amend broader fiscal-monetary institutions and reforms. It is plausible, for example, to believe fiscal integrity might be attainable by a balanced budget amendment, by a privatization of entitlement spending, by a restoration of the gold standard, or by the introduction of nation-wide value-added tax; yet such reforms would be (and typically are) opposed precisely due to their likely effects.

In some important respects public debt theory in the public choice perspective seeks to revive the case for fiscal orthodoxy as laid out by the classical economists in the 18th century, but absent the classical economists’ errors (the wage-fund doctrine, the labor theory of value). Public choice theory on public debt also revives aspects of neoclassical public finance theory, which applies subjective value theory and marginal productivity theory to public deficit-spending, coupled with the political presuppositions of theorists like Vilfredo Pareto (1848-1923), who advocates an individualist standard of efficiency and optimality, Knut Wicksell (1851-1926), who opposes un-limited majority rule and its tendency to generate fiscal integrity, and Antonio De Viti De Marco (1858-1943), who, as we shall see, distinguishes the free state, which is concerned for the rights and well-being of the individual and separate person, and the monopolistic, fascistic state bent on subordinating the individual and confiscating his wealth. In tracing the historical roots of public choice theories, Backhaus and Wagner (2005, 314) distinguish an Anglo-Saxon orientation in fiscal analysis from a
Continental orientation – and contend that contemporary public choice analysis adopts the latter:

[There are] two relatively distinct analytical orientations toward fiscal inquiry, reflecting different conceptualizations of the relationship between the polity and the economy. One orientation, which we label the Anglo-Saxon orientation, conceptualizes the policy as independent of or autonomous from the economy. The other orientation, which we label the continental orientation, conceptualizes the relationship between the policy and economy as mutual and reciprocal. Within the Anglo-Saxon orientation, fiscal theorizing proceeds independently of political regimes and fiscal institutions. Taxes are treated as sacrifices regardless of the regime within which they are extracted. A fiscal scholar might well acknowledge that regimes differ in how much attention they give to the minimization of sacrifices, but the conditions for minimization are themselves independent of regime. Public finance is thus “the study of government intervention in the marketplace” [according to Raghbendra, in his 1998 text, Modern Public Economics, p. xii]. Within the Continental orientation, by contrast, public finance is the study of how people participate through political and fiscal institutions to generate fiscal patterns and outcomes (Buchanan 1967 [in Public Finance in Democratic Process: Fiscal Institutions and Individual Choice] is an exemplary treatment within this orientation.

Likewise, in his Nobel lecture Buchanan (1987) acknowledges Knut Wicksell as a major influence, and opens his remarks by citing him, to the effect that “the science of public finance should always keep . . . political conditions clearly in mind.” More recently, Buchanan (2010) supplements the interpretation of Backhaus and Wagner (2005) that public choice incorporates a Continental orientation about the relation of the polity and economy, as he traces the roots of his initial insights on public choice in the period subsequent to his year-long stay in Italy, as a visiting scholar, in the 1940s:

I went to Italy to understand and learn about the Italian tradition in public finance, but the effect [on me] really was to change my whole view about politics,
the state, and man’s relation with the state. I absorbed a lot of the Italian thinking there, without realizing quite how important it [would become] to my own career. I don’t think public choice or the approach that I took in a lot of my other research would have ever got off the ground, certainly not in the same way, had it not been for the Italian influence. My first piece in 1949 [argued] that people should in fact pay a little attention to the model of the state, and I notice, looking back at that piece, that I did have a reference to De Viti De Marco’s book [First Principles of Public Finance, 1936] which was the only book that had ever been translated from that tradition into English. Apparently [De Viti De Marco] had much more influence on me than I realized [at the time], because I did cite that book in my paper. The thing that I can point to . . . as always in the back of my mind, is this idea of how to model the state, and his development of the idea of two parallel models of the state – the monopoly model and the democratic model – carries through [to my work]. One important influence of the Italian year on me was not only reading this material but also living there, living in the culture, becoming part of the culture, and seeing the attitude of the Italians towards politics, politicians and the state – much more skeptical, much more cyclical, much less idealistic, much less romantic about the state – and that influenced me a great deal, because, as I said, I don’t think I ever would have had an influence in public choice so much had that not given me a feel for a way of looking at the state. (Buchanan 2010)

Buchanan’s latest acknowledgement of the influence on his thinking of Italian public debt theory in general, and the approach of Antonio De Viti De Marco (1858-1943) in particular, caps a half-century of influence: the influence is apparent as well, and decade ago, in a chapter sub-section by Buchanan titled “The Italian Contribution to Debt Theory” (Buchanan 1960, 51-59), which itself is a slightly-expanded version of a prior treatment, appearing in Buchanan’s 1958 book (88-94). Thus before examining Buchanan’s theory in depth, it is worthwhile examining De Viti De Marco’s own ideas on public debt, and those also of some precursors to a public-choice approach: the long-time professor of public finance at Princeton University, Harley Lutz (1882-1936, 1945,
and 1947) and the famed Austrian economist, Ludwig von Mises (1881-1973), who emigrated to the U.S. from war-torn Europe in the early 1940s, and taught sporadically at New York University.

5.2 De Viti De Marco: Public Debt as Deferred Taxation

Antonio De Viti De Marco (1858-1943) was a classical liberal, a land-owning aristocrat, and, during the first two decades of the 20th Century, a parliamentarian in Italy. He began as professor of public finance in Rome in 1887, and taught at the university until 1931, when he resigned after refusing to take a loyalty oath to Mussolini’s fascist regime. De Viti De Marco was “an unyielding defender of liberalism.” (Cesarano 1991) His classic text, *First Principles of Public Finance* (1936), first published in Italian in 1888, was described by a reviewer (of an earlier version of the text) as “probably the best treatise on the theory of Public Finance ever written.” (Benham 1934). In his own words, De Viti De Marco aimed to “treat Public Finance as a theoretical science, assigning it the task of explaining the phenomena of Public Finance” – i.e., spending, taxing, and borrowing – “as they appear in their historical experience,” and by a method that is “objective, impersonal and theoretical, in contrast with an approach founded on *a priori* canons of absolute justice, which does not exist.”

De Viti De Marco maintains that traditional public finance analysis had been contaminated by overt political prejudices, by “personal ideals of social justice,” and the expediencies accompanying “practical statecraft.” (1936, 15-16) “In modern society,” he
contended, “all income is produced as a result of the free activity or free choice of the citizens,” and “from this is derived the juridical premises of equal fiscal treatment of all incomes;” further, “every deviation from this principle” “is an acknowledgement of the presence of a political factor, the nature of which must be ascertained and the relative influence of which must be evaluated (16). De Viti De Marco opposes redistributionist policies and the arbitrariness with which he feels they are promulgated and enacted. The classically-liberal state he characterizes as “cooperative,” while the interventionist state is “monopolistic,” and their fiscal practices differ considerably; the cooperative state treats citizens, especially income-earners, with respect, as if partners, while the monopolistic state is predatory and exploits them for the sole benefit of the ruling class.

De Viti De Marco’s “Theory of Public Loans” is presented in Book V, Chapter I of First Principles of Public Finance (1936, 377-398). He first distinguishes “ordinary, normal, and continuous expenditures” from their opposite, what he calls the “extraordinary needs” of state which “arise at great intervals,” and whereas the former are best financed by taxes, the latter are best funded by borrowing. In all events, state financial needs must co-exist peaceably with those of citizens, and thus “we start with the elementary premise that the budget of modern States develops in harmony with the budgets of the citizens, the two together representing the organic budget of the nation.”(378) De Viti De Marco holds that public debt originates in the state’s demand for large tax revenues in extraordinary cases and times, while most citizens will find the
proposed charges affordable, at least if payable over time, they may be property owners and hence not liquid enough to pay the extraordinary taxes in cash; they borrow from other private parties, those with liquid capital. So also, then, the state may borrow from these same cash-rich parties – these public creditors – and, in effect, stand in the place of those who have the necessary wealth but are too illiquid to pay the extraordinary one-time tax; the state taxes them later, and over time, in smaller, steadier sums.

For De Viti De Marco the process of public borrowing, including the perpetual turnover of public holdings of liquid, negotiable securities, amounts to “the raising of an extraordinary levy through the flotation of a public loan” but by “less of a burden than an extraordinary tax on property would cause,” and whereas it is impossible to tax non-citizens abroad, “the public loan broadens the market of subscribers to the extent that it attracts foreign investors,” and “to the extent that the circle of initial subscribers is enlarged, the financial needs of the State remaining constant, the burden of the extraordinary levy on the country’s economic structure is lightened.” (385) Since “the institution of the public loan is a more economical fiscal instrument than the extraordinary tax on property,” in the end “it takes the place of the latter.” (387) “On this network of private loans is founded the theory of public loans,” De Viti De Marco writes, and “in fact, the State can abolish the instrument of extraordinary taxation” altogether “if it asks as a direct loan from the group of ‘capitalists’ the total sum that they were prepared to lend to the owners of immobile property, and if, at the same time,
[the State] asks from the owners of immobile property a sum [in future taxes] equal to
the interest that they were prepared to pay the ‘capitalists,’” had they instead been
required to borrow from them, to pay the extraordinary tax. (382) In this way the state
“makes itself intermediary between private lenders and borrowers, combines in a single
inclusive figure the sums demanded as loans, contracts in its own name a single loan for
the total amount it needs, and obligates itself to pay a uniform rate of interest.” (382)

Note how De Viti De Marco conceives of public borrowing as a peaceful,
beneficial exchange: the cooperative state requires a large, one-time (“extraordinary”) sum, which it could, by right, gain through a tax, coercively, but that would harm illiquid taxpayers; instead it achieves the same end by efficiently facilitating an intermediation
of credit. In this same vein he stresses that public bonds are purchased by a “voluntarily subscription,” so “there is, therefore, an advantage to both of the contracting parties,” that is, to state and creditor alike. (383-384) De Viti De Marco is aware of the potential for what later was called “crowding out,” and how this might affect interest rates. “The State competes for the available savings against industry and commerce, which also exercise a demand for them,” he notes, and “what decides the distribution of savings between the Treasury and industry is the rate of interest paid by the State.” (388). The state might pay the market interest rate, a higher rate than that, or even a lower rate.

Like J.S. Mill, writing on public debt in the mid-19th century, who also sought an
objective measure of the excessiveness (or not) of public indebtedness, De Viti De Marco
looks to the interest rate the borrowing government must pay. “The higher the rate of interest promised by the state,” he says, “the more available savings it withdraws from industry and commerce, with resulting disadvantages similar to those produced by excessive rates of extraordinary taxation.”(389) But if, in borrowing, the state need only pay the market rate, or less, there is no burden or crowding out of private sector needs, and “disposable savings will be distributed between the Treasury and industry according to which use offers the greater advantage to the savers.” In such cases public debt “will not disorganize the vital nucleus of the industrial activity of the country.”(389) Again, the cooperative state refrains from harming markets.

Public debt, for De Viti De Marco, is best conceived as a form of taxation – as deferred taxation – but with the cooperative (not monopolistic) state working to ensure citizens are not too burdened and pay with as little pain as possible, in this case by the equivalent of an installment plan. But he also argues that whereas taxes paid now necessarily “induce each taxpayer to lower” “his present standard of living” (379), public debt, means the citizen necessarily “will have to reduce permanently his future standard of living.”(378) In other words, the fact is inescapable that whenever the state finances itself, private incomes (and living standards) must decline, and it is only a question of whether this decline must occur presently (taxes, paid up-front) or over time (debt – or deferred taxes – paid in the future).
In this way De Viti De Marco denies that either tax-financed or debt-financed spending are neutral towards (or perhaps supplement) citizens’ living standards, whether currently or for posterity (378-379), but elsewhere he writes that while “the heirs and future generations will receive from their ancestors a budget which, on the liability side, is depreciated by the amount of the [public debt],” “the asset side” of their ledgers will be “increased by the utility” that still results from the initial outlay. (395)
This suggests public spending on long-lived capital goods or infrastructure, instead of spending dissipated near term, on consumption. For De Viti De Marco, public spending can yield current and even trailing utility, but in neither case is this marginal utility sufficient to offset the disutility of servicing future debt, and thus not supplemental to living standards, now or in the future. Buchanan’s major difference with De Viti de Marco, on public debt, pertains to the latter’s implicit embrace of Ricardo’s finding, on purely mathematical grounds, that an equivalence exists between a tax-financed and debt-financed sum of state spending. Although Buchanan, we will see, holds public debt to be nothing more nor less than deferred taxation, and on that score, at least, agrees with De Viti De Marco, he also believes, as the latter does not, that public loans involve a burdensome and largely-uncompensated cost-shifting to future generations. For Buchanan this cost-shifting is detrimental not only because it entails a bias toward profligate deficit-spending in the present, but because it is unfair to posterity. Future generations are not represented in the political system that imposes political obligations.
on them (by issuing long-term public debt); they do not (indeed, cannot) give their consent to such political acts, and thus are effectively disenfranchised. In contrast to this view, De Viti De Marco contends as follows:

[T]here is no basis for the old, but still widespread opinion that a [public] loan, unlike an extraordinary tax on property, makes it possible to shift a part of [the cost of] public expenditure to future generations. On the contrary, in every case the heirs either receive a patrimony which is lessened by an amount equal to the capital sum involved, or are held responsible for the continuing payment of the corresponding amount of interest; there is, as we have seen, no difference from a financial point of view. The heirs who pay perpetual interest can redeem their obligation by paying a corresponding capital sum. But this operation is voluntary, and does not represent a burden; if it is carried out, this is because it is hoped to derive a gain thereby. (396)

What of the supposed internal burden of public debt, beyond what De Viti De Marco interprets as a necessary diminution in the living standards of current and future taxpayers who must service the debt, with (apparently) no sufficiently-valued, corresponding public asset by which to achieve a net benefit? “The loan burdens the budget of the State with a new expenditure in the form of interest,” he writes, but to this “there corresponds a revenue equal in amount.”(390) Do we then “owe it to ourselves,” with no net societal burden? Yes, but it is important to disaggregate the flows, for they affect the economy. “For the State it is a matter of debit and credit,” he writes, “but this is not true of the economic budget of the community, as has sometimes been alleged.” Recall De Viti De Marco’s view that there is an economic budget for the state and one for the citizenry, which together comprise a unified national budget. But “the community is
not a homogenous group, which pays 50 million in taxes and receives 50 million in interest,” he adds, for “the State receives 50 million in taxes from one group of citizens and pays 50 million to another group.” (390) The only way to avoid such a redistribution of income – and ensure that “the State treats all taxpayers uniformly – is to make taxpayers and public creditors same people, paying and receiving the same amounts as regards taxes and interest income from public bonds.”

This is another example of De Viti De Marco, the classical liberal and political individualist, practicing methodological individualism, or the art of separating out the causes and effects operating within what appears to be a purely aggregative process, of considering not merely a “society” (or “community”) but the groups, and better still, the individual persons, comprising it. In this regard he notes with favor what he calls the gradual “democratization” of public debt: as a nation becomes wealthier, so also does a growing proportion of its people (through the spread of a middle class), and instead of living on a subsistence level, more people are able to prosper and save, which means more also are able to purchase and hold public debt and receive its interest income, partly offsetting its taxes. In this way not only the professional financier and bondholder but “the capitalist, the [business] proprietor, and the professional man” are able to partake of income from the state. (392) And importantly, for De Viti De Marco, though a vast public debt may remain due, the democratization of its distribution means, “at this moment,” that it “may be regarded as extinguished in fact.” (392) In effect, he says,
the adage that “we owe it to ourselves” is valid, but only insofar as the “we” is comprised of the same people as the “ourselves.” Of course, no public debt is truly “extinguished” merely because it is more widely (that is, democratically) held; yet for De Viti De Marco, “this proposition, by virtue of its truth as an abstract proposition and its truth as a statement of concrete tendencies, demolishes the current opinion that modern States, because of their enormous expenditures in the form of inters-payments, will not, in the long run, be able to bear the weight. On the contrary, the burden of the loan on the economic position of the taxpayers is borne entirely at the moment of subscription, when provision is made” in the annual budget to pay interest, and so, “as we get further away from the time of [the original bond issuance], the tax-burden of the loan becomes progressively less.” Although “there remain the alarming figures of the original public debts and the interest on them,” “the interplay of debits and credits tends gradually to make them devoid of any economic content.”(392-393)

Clearly, De Viti De Marco believes public debt can be a true burden only if narrowly-held, say by a financier class, and thus dependent for its servicing primarily on other (non-financial) classes in a society. This view, that public debt is less of a total burden to society – or none at all, regardless of its magnitude – so long as it is widely-held, later became the grounds for the reporting and analyzing of official data as “gross” versus “net” public debt, with the differential deemed no burden because held by state trust funds or agencies (that is, held “democratically,” on behalf of all of a nation’s
people). For De Viti De Marco, no matter how large public debt may become, if it is widely-held there is no real cause for alarm; that it is, indeed, widely-held also indicates a richer nation which can more easily afford to service its public debt. It is futile and harmful, he contends, for public finance officials to so worry about public debt as to try to reduce or worse, extinguish it entirely, whether by tax hikes or more odious means (like deliberate repudiation). He prefers to leave “the solution of the problem to the natural play of economic forces,” but worries that this option is precluded when policymakers are “dominated by the idea that every debt contracted formally and publicly must be formally and publicly extinguished.” There is no need of this, he argues, and although “it would not be true to say, in accordance with an old belief” (held by mercantilists), “that the public debt is a part of the wealth of the country,” yet it is undeniable that “its presence and its continuance in the market produces an additional utility,” for public debt “often renders subsidiary services in the facilitation of credit operations between private individuals,” due to its safety and liquidity in the marketplace, and this marginal utility “must be taken into account.”(394)

De Viti De Marco contends that the rational state demonstrates its financial rectitude and credit capacity, ultimately, by keeping its promises and making its required payments, not by unnecessarily or harmfully reducing or redeeming its debt: A State that has already had recourse to borrowing may need to have further recourse to it. Good financial policy, foreseeing this, must keep the credit of the State high; and the credit of the State, like that of an individual, depends not only on the real solidity of its finances, but also on the opinion of its finances which is
formed by the market. Now, only when the State pays its debts does it give visible and tangible evidence that the proceeds of a first loan have not been invested at a loss and that, in any case, the savings of the debtor country which asks for new credit have increased in the interval. (395)

For De Viti De Marco, the financially-strong state inspires the confidence ("opinion") of markets (especially of taxpayers and bondholders), not merely by publicly showing off its financial muscles (by maintaining its public credit), but also by using and exercising such muscles (by issuing and properly servicing its public debt). Whereas public credit pertains to a state’s capacity to borrow, public debt pertains to its actual use or deployment of the capacity. Both are crucial to any state exhibiting maximum financial (and ultimately, political-military) prowess. According to De Viti De Marco, public finance officials need not become alarmed about the actual magnitude of outstanding public debt, nor obsessed about some absolute, out-of-context debt number; they need only be concerned with the gap between debt prowess and debt usage – with the margin between the state’s capacity to borrow (public credit) and its actual borrowing (public debt). In contemporary analysis this contextualized approach is captured in ratio of public debt to GDP, yet GDP itself is not the whole of the matter, for nations with similar GDP can experience quite different taxable capacities.

De Viti De Marco warns that this crucial margin between capacity (public credit) and usage (public debt) must not be too narrow, for if it is, a nation’s credit capacity will be dangerously close to exhaustion. Instead of preserving or widening this margin by
reducing or extinguishing public debt, potentially by odious means, states should work to enlarge their credit capacity, which depends on a nation’s taxable capacity, which depends, further, on the private economy’s productive (income-generating) capacity – a capacity that is maximized by the policies of liberal, cooperative, and free states, not by the policies of statist, monopolistic, and predatory states. States can borrow and spend on loss-making projects, but then the problem is the project, not how it was funded (and tax revenues too would have been wasted).

States generally can become too large and oppressive relative to an economy’s productive capacity and operating flexibility, according to De Viti De Marco, and thus “many criticisms which have been wrongly directed against borrowing as such could with more justice raised against the nature of the extraordinary expenditure” (395) which causes equally-extraordinary (and excessive) deficit-spending and debt accumulation. If anyone is to discern a problem with deficit-spending per se, De Viti De Marco contends, he should discern it in the spending side of a fiscal operation, not in the financing (deficit-debt) side of it, and further, in any political aim that entails nullifying citizens’ voluntary choices and the maximization of their hedonistic utility. Above all, sovereigns must repay honestly, not by unnecessarily, harmfully or unjustly skirting its obligations:

[T]he problem resides in the purpose – that is, in the type of expenditure – not in the means of procuring the necessary sum. Those who would have the political strength to force a government to adopt an extraordinary tax instead of a loan would have the political strength to prevent the expenditure which they consider harmful to the country. Another sterile discussion is that inaugurated by those who champion the extraordinary tax against the public loan on the ground that
the former obliges the present generation to increase its savings, which later accrue to the advantage of future generations, who inherit a larger patrimony. This opinion has a basis of truth, in so far as – ceteris paribus – private loans, which bear a fixed maturity date and a higher interest rate, induce the debtor to free himself from them, whereas the public loan allows him more time and greater freedom of movement. Even if we admit that this is true, it has not been shown that it is useful. The action of the State that would force the savers to reduce their present consumption below the limit which they consider useful for their well-being runs up against the economic principle according to which the individual attains the hedonistic maximum when he is left to distribute his income between the satisfaction of present wants and the satisfaction of future wants, according to his own appraisal. . . . [It is not ] useful to the community, considered in its entirety over a period of several generations, that a first generation should be induced to save to the maximum, in order to permit one of the following generations to consume to the maximum. The economic principle referred to above, which is valid for the individual, must be assumed to be true also with respect to the aggregate of individuals who make up a given generation. (397-398)

Here we see that for De Viti De Marco there exists an all-important distinction, in public finance, between debt and taxes: the purchase of a public debt security is voluntary, hence amenable to a self-interested, utility-maximizing calculus, while the payment a tax is compulsory (and a large or “extraordinary” tax, payable at once, perhaps requiring a fire-sale of assets, is both coercive and confiscatory). All else equal, then, as a classical liberal, he would much prefer to see debt than taxes. Only the liberal political regime cares about this distinction, and is careful to try to minimize whatever burdens might be felt in any scheme of public finance. For De Viti De Marco the public loan should be preferable to a tax “upon the assumption of the existence of a liberal and democratic State and at a time when all the individual citizens” are “universally
accorded the right of participating, in some way and in some degree, in the formation of the financial evaluation of public costs in relation to public utilities.’(398) Yet he concedes, in the 1930s, that liberalism is fast-declining, globally, while fascism and communism are ascendant; as such, tax-based, inflationary, and confiscatory financing schemes are also spreading. In statist regimes the evaluation of public outlays and finances is less participatory, for it is “left to a single individual or a small oligarchy,” with the result that “a political equilibrium cannot be attained unless the appraisal of the one coincides with the suppressed evaluation of the many.”(398)

Again we observe De Viti De Marco’s clear preference and sympathy for political liberty, alongside a barely-disguised contempt for predatory states, although the latter sentiment is couched in the cool prose of positive analysis, as when he attributes autocracy’s failures to its inability to attain a “political equilibrium.” But we can also discern the beginnings of a thesis which De Viti De Marco may not have intended ever to launch: that freedom-respecting democracies, relative to liberty-crushing autocracies, are more prone to public deficit-spending and debt accumulation, not only because they tend to be richer (thus more able to afford higher debt service), and not only because they tend to adhere more to the rule of law (and thus better elicit creditors’ trust), but most importantly, perhaps, because they are more likely to endorse a system of public finance which relies relatively more on borrowing than on taxing, for the very reason
that it is more conducive to liberty, voluntary choice and utility maximization. By all accounts De Viti De Marco is most accurately characterized as a realist on public debt.

Although De Viti De Marco’s *First Principles of Public Finance* appeared in an English translation in 1936, the same year as Keynes’s *General Theory*, and although it proved historically important to the development of public finance and public debt theory, and to the evolution in Buchanan’s thinking on public choice, most of it was written in Italian, in the late 19th Century, so by 1936 it could not possibly serve as authoritative commentary, direct or otherwise, critical or not, on Keynes’s theories of deficit spending and public debt. Yet because De Viti De Marco’s book made the important and innovative distinction between the public finance practices of the right-respecting “cooperative” state and the predatory “monopolistic” state, it turned out to be far more helpful to an accurate comprehension of the political economy of the 1930s than to that of the 1890s. Indeed, public choice theorists might well say De Viti De Marco’s book, without directly aiming at the Keynesian system, nevertheless implicitly addressed its essence, including its claims about being most applicable in a monopolistic or predatory state, as even Keynes declared, not only the introduction to the German-language edition of his *General Theory*, but in the text, where he calls for a vast socialization of investment and policies to “euthanize” bondholders, and as Lerner later argued, even more forthrightly, in *The Economics of Control* (1944).
Moreover, De Viti De Marco’s book provides important theoretical girders and scholarly inspiration for public choice debt theorists, whose first major case for a new view of debt came in 1958, with Buchanan’s *Public Principles of Public Debt: A Defense and Restatement*, and whose first feature-length assault on Keynesian (not necessarily Keynes’s) debt theory and practice came in 1977, with the publication of Buchanan and Wagner’s *Democracy in Deficit: The Political Legacy of Lord Keynes*. It was not Keynes himself but his “legacy” (as embodied in the Keynesians) that so troubled public choice theorists. Although foundational for public choice, De Viti De Marco is a public debt realist, while public choice theorists are, for the most part, public debt pessimists.


### 5.3 Early Hints of a Public Choice View: Clark, Williams, and Moulton

Before investigating more deeply the key themes in public debt presented by Buchanan, Brennan and Wagner since the appearance of Buchanan’s path-breaking *Public Principles of Public Debt* in 1958, it is worth recovering some of the more important public debt insights of scholars in the 1930s and 1940s. Although not strictly operating in
the public choice tradition, nevertheless they anticipate many of its important concerns and themes, including 1) a general pessimism towards public debt, 2) a suspicion that the motives of political actors are more likely to be self-aggrandizing than public-spirited, and 3) a rejection of Keynesian programs of deficit-spending and public debt build-up. We shall briefly examine the main treatments of public deficits and debts by John Maurice Clark (1884-1963, professor of economics at Columbia University, 1926-1957), John H. Williams (1887-1980, professor of economics at Harvard University, 1921-1957, and first dean of the new Harvard Graduate School of Public Administration, 1937-1947), Harold Moulton (1883-1965, professor of political economy at the University of Chicago and first president of the Brookings Institution), Harley L. Lutz (1882-1975, professor of public finance at Princeton University, 1928-1947), and Ludwig von Mises (1881-1973, visiting professor of economics at New York University, 1945-1969).

From a public choice perspective, the value in Clark (1939), Williams (1941), Moulton (1943), Lutz (1936, 1938, 1945, 1947), and Mises (1949), lies in the fact that they offer early and critical assessments of Keynesian notions about deficit-spending and public debt – whether billed as the “socialization of investment,” “pump-priming,” “compensatory finance,” or “functional finance” – and before it was fully understood what these notions truly meant, or how long they might persist as official policy. These writers are also skeptical that the motives driving political actors to promote and enact such policies are “public-spirited” or instead essentially predatory, especially as they
meant a dramatic expansion in the size, scope, and cost of the state, not perhaps for the benefit of the private sector, but at its expense. Lutz is perhaps the sole debt realist in the group; the others are primarily pessimists, regarding not only debt but state motives.

Clark (1939) and Williams (1941) alike provide critical but tentative assessments of the public debt explosion of the 1930s, and of what was, to some observers, a full-scale Keynesian case for unrestrained deficit-spending, but to others was mere quiet assent, as a mere lesser evil (compared to tax-hiking). The critics following Clark and Williams – Moulton, Lutz, and Mises – were more consistent and forceful in their analyses.

In the U.S. of the late-1930s, after a decade of economic depression and an average jobless rate of 18.2% (and 20.7% even in spring 1939), the public debt more than doubled, from $17 billion in 1929 (16% of GDP) to $40 billion in 1939 (44% of GDP). The U.S. public debt ratio in 1939 was higher even than the peak debt ratio of World War I (34%, in 1919). After World War II the U.S. debt ratio would move higher still, as debt jumped from $40 billion in 1939 to $269 billion in 1946 (121% of GDP). During the 1930s nearly 39% of all U.S. federal spending was borrowed. In contrast, in England, Keynes’s home country, the central government borrowed only 5% of total outlays, and Britain’s public debt ratio declined during the 1930s. On average Britain’s jobless rate was also lower than the U.S. rate in the 1930s, and whereas U.S. industrial output in 1939 was 9% lower than a decade earlier, in England it was 21% higher. Ironically, Keynesian policies were less-needed and/or less-adopted in the U.K. than in the U.S. If scholars at the time
knew this data, it may have suggested to them that U.S. deficit-spending, instead of mitigating an initially-mild contraction, merely reflected it, or worse, deepened it.

Clark (1939) believes there is some truth to Keynes’s claim that deficit-spending can stimulate demand an output, even arguing that it might “produce an industrial expansion,” but the effect would likely “dwindle rapidly and disappear if the deficit-spending stops.” “It is highly improbable,” he wrote, “that this form of stimulus can itself serve to initiate a revival that will endure after the stimulus is removed.” In fact, he maintains that “indefinite deficit spending is not an endurably workable remedy for chronic, partial stagnation of an economic system like our own.” Instead of Keynes’s socialization of investment, Clark believes that “a free flow of private investment” is the “prime requisite of success,” and if anything, deficit-spending tends to displace or undermine private investment, by diminishing business confidence. “If businessmen expect the public deficit to continue for a long time and in large volume, they will be affected by fear of ultimate impaired public credit, or of inflation, or, if not these, then at least by fear of burdensome taxes in the future.” For Clark “these are all retarding forces,” and worse, are caused by the same deficit-spending and debt accumulation policies that Keynes wrongly asserted would prove ameliorative. On the other hand, in support of Keynes, Clark denies that public borrowing in the 1930s is crowding out other credit; private sector loan demand and interest rates are too low, he says, to support such a claim. He also denies that the public debt is a net burden to the economy,
yet is attentive to disaggregating the effects, a method typical of later public choice analysts; for Clark, while “there is nothing self-limiting about the debt the government is piling up,” and it may seem troubling that the debt “goes on increasing without limit,” nevertheless “it does not represent a net burden of this amount on the economic system as a whole.” Our real concern, he says, should be for the way the public debt “does represent an obligation on Americans as taxpayers to transfer ever-increasing sums to Americans as bondholders.” Oddly, his concern begins only after bondholders have transferred their capital to taxpayers, via the state. But concurring with many prior debt theorists, Clark believes public bondholders are unproductive, or at best, passive financiers of an unproductive entity (government), so any larger role they assume in credit markets due to purchases and portfolio accumulations of public debt “will retard business activity materially.” Clark does not suspect that financiers may be lending to the state only because business activity already is retarded or unsafe.

Paying some attention to the actual spending that deficit-spending entails (as did Keynes, who insisted that outlays be restricted mainly to public capital projects, not to mere consumptive transfers), Clark (1939) warns that infrastructure projects are not so easily or quickly launched, nor are they typically sufficient in number or of financial magnitude to make a material difference in a large economy, and worse, they are prone to political patronage and invite wasteful rent-seeking. In short, Clark presciently identifies many of the same risks that seem to bedevil “stimulus” spending schemes to
this day. “We have not reached the limit of our debt-bearing power,” Clark contends, “but we do seem to have reached a point at which the piling up of public deficits is a deterrent to private capital outlays,” and unfortunately, the likelihood now (in 1939) is that the Treasury “will be treated as a bottom-less grab bag for pressure-group interests.” Despite voicing this public choice theme (rent-seeking), Clark concludes by tentatively endorsing the usual grab bag of Keynesian ideas – including keeping wage rates “as high as possible” (despite a sky-high jobless rate), ensuring “low interest rates” (even as public bondholders are reluctant to take risks), and imposing confiscatory tax rates to curb “high profits” and preclude “a top-heavy scale of income distribution.”

A professor at Harvard since the early 1920s, John H. Williams specialized in trade and monetary theory, but in his 1941 article, “Deficit Spending,” he tackled, for the first time publicly, what seemed to be the linchpin of the Keynesian policy for recovery from depression in the 1930s. The problem, by 1939, was that no real recovery was either visible or foreseeable, despite record peace-time deficit-spending. Keynesians began to argue that recovery was elusive because too small a dose of the new fiscal medicine had been administered, or because, in the phrase of Alvin Hansen (the “American Keynes”), capitalism now suffer from “secular stagnation,” which no mere counter-cyclical fiscal or monetary policy could effectively forestall. More drastic (interventionist) measures would be required, and some Keynesians and FDR New Dealers viewed Europe as a model for new veins of state intervention, including the Continent’s penchant for war.
Indeed, Keynes had said, in his *General Theory* (1936), that war could cure an economic depression, for it could simultaneously lower the jobless rate by conscripting the idle and sending them abroad, eradicate “over-production” by overt wealth destruction, and absorb “excess saving” by huge state borrowing and spending on projects of dissipation. In 1937 Williams had recruited Hansen from the University of Minnesota to Harvard, and the two organized and taught the famous Fiscal Policy Seminar, attended by students, academics, and policymakers, at the new Harvard Graduate School of Public Administration, where Williams served as dean from 1937 to 1947. Although Williams generally opposed Keynesian policies, he also helped Hansen achieve influence and fame, such that he became a world-renowned Keynesian.

In “Deficit Spending,” Williams (1941) seems like a proto-public choice theorist, for he treats not only the economics of deficit-spending but the politics behind it (plus the politics resulting from it). He contends that deficit-spending lacks coherence, both logically and economically, that it only became official “policy” by default, in the aftermath of the failure of the Federal Reserve’s earlier low-interest-rate policy, which sought to foster a lasting recovery; now, he argues, deficit-spending is being pursued mainly to rationalize a more expansive economic role for government, and perhaps a more expansive role as well, within government, for its advocates and their interests, within the state, a common aspiration for many academic economists in the 1930s.
Williams identifies three ideational phases in the theory and practice of deficit-spending in the 1930s: first, the policy was presented as the passive but unavoidable result of economic depression and plunging tax revenues; next, it was defended as a means of preventing a still-deeper economic decline; finally, the larger claim was made that deficit-spending could boost virtually any economy, from any level, through mysterious “multipliers” or “accelerators,” as if magically. Williams says it is difficult to pinpoint when FDR’s New Dealers promoted these shifts, but they occurred, and, he suggests, not by patient economic analysis but according to political expediency; to ensure their positions, academics and advisors often pretended to believe in the policy.

As for the deficit and public debt policy of American New Dealers under FDR in the 1930s, Williams (1941) relates how “many persons within the Administration favored deficit spending as a deliberate policy for recovery considerably before such a policy publicly emerged,” and that during his first term (1933-1937) FDR had pledged to balance the federal budget by restraining government spending. “There was,” Williams writes “little or no evidence [in 1933] that public spending was to be a major policy of recovery.” However, Keynes’s influential visit to the U.S., in June 1934, triggered greater interest in this new policy direction; Williams cites Keynes as saying “that if we [in the U.S] spent $200 million a month [in excess of tax revenues] we could go back to the bottom of the depression, that a net monthly deficit of $300 million would hold us even, and one of $400 million would bring full recovery.” For context, the U.S. federal budget
deficit was $2.6 billion in 1933 ($217 million per month, on average); it then widened, to $3.7 billion, in 1934 ($302 million per month); it narrowed amid an economic rebound in 1935, but then reached its widest width in 1936, at $368 million per month, but soon thereafter the U.S. economy severely contracted again, during 1937-1938.

For Williams (1941), the increasingly aggressive push for deficit spending in the 1930s reflected “an inevitable human tendency to rationalize experience.” The deficits were only the “logical sequel to central bank policy,” because “the financing of deficits represents a further step toward making an easy money policy effective.” Williams was not unilaterally opposed to deficit spending; he writes, for example, that “the underinvestment thesis has a better factual foundation than the over-saving theory,” that “in the business cycle deficit spending can be of real assistance,” and that nothing he argues should be taken to “suggest that we should discard compensatory fiscal policy.” But, he concludes, “the case for permanent deficits as compensation for over-saving and under-investment tendencies seems to me unproved and based in considerable measure upon misconceptions of the nature and effects of the secular economic changes we are observing.” Thus Williams could entertain Hansen’s notion of “secular stagnation,” without endorsing the related claim that perpetual deficit-spending might cure it.

Williams also opposes chronic deficit-spending because, he says, it threatens democratic capitalism: “My own view is that such a ‘grand experiment,’ besides being
politically impossible in a democracy,” would end up “probably destroying democracy,” because it would “eventually break down or would entirely transform our democratic, private, capitalistic system.” Over time “its costs would become a constantly increasing fraction of the national income.” Far better a policy it would be, William argues, especially given that under-employment is the root problem, to encourage a decline in wage rates (although not in the total wage bill), rather than preserve artificially-high wage rates by deficit-spending. Keynesians rejected such advice, mainly on the grounds that labor unions would not abide lower nominal wage rates, even as they saw real wages rising, jobless rates skyrocketing, and employers facing a five-year, 30% price deflation, accompanied by collapsing revenues and a flood of red ink.

### 5.4 Proto-Public Choice Suspictions of State Motives: Lutz and Mises

Harley Lutz (1882-1975) was the pre-eminent professor of public finance in America during the first half the 20th century; he taught at Oberlin, Stanford, and for the last two decades of his career, at Princeton University (1928-1947). Lutz authored numerous articles as well as a widely-used textbook (Public Finance) which appeared in four editions over a period of dramatic change in the field (1924, 1929, 1936, 1947). When in 1997 Princeton professor Harvey Rosen, co-author of today’s most-used public finance textbook (Rosen and Gayer 2009), sought to contrast the current state-of-the-art with what prevailed a half-century prior, he chose, as the most representative text, the 1947 (and last) edition of Lutz’s textbook (Rosen 1997).
That Lutz’s 1947 text might be “representative” of the time, when the U.S. Debt/GDP ratio had reached an all-time high of 121% (1946), is, perhaps, remarkable, because Lutz was no political-economic moderate. He defended constitutionally-limited government, proportional taxation, balanced budgets, and the gold standard; as such he criticized the growth of government after World War I, as well as deliberate deficit spending, the graduated income tax, and inflation. His arguments were more muted in his textbook, but were made more directly and forcefully in such books as Guideposts for a Free Economy: A Series of Essays on Enterprise and Government Finance (1945).

As we will see, Lutz is the last of the prominent American realists in public debt theory, in a lineage traceable to Treasury secretary Alexander Hamilton in the 1790s. That Rosen takes issue with Lutz’s approach to public credit and debt is telling, and may serve as a good entry point for our analysis of Lutz’s approach. According to Rosen, Lutz improperly incorporates “normative issues” into his treatment of public credit and debt, or at least fails to derive ethical norms from a priori “models.” Moreover, Rosen believes Lutz is insufficiently positivist (formalistic) and pragmatist (non-principled), hence too focused on finding “practical principles” for government behavior:

[In Lutz 1947] bits of economic theory are present, but they are not brought to bear systematically on the problem. Instead of deriving normative results from models, they are presented as “principles.” For example, in [the 1995 edition of my own public finance textbook] the choice between debt and tax finance is viewed to a large extent through the prism of Barro’s model, in which the two methods are compared on the basis of the present value of their excess burdens. In contrast, [Lutz’s 1947 textbook] lists a series of “Principles of Public Credit” including character (will the government repay the debt); capacity (for what
purpose will the government use the credit); and financial resources (the government’s ability to pay interest and principal). These are sensible criteria to use when thinking about public debt, and it is not at all clear that they are less important than the excess burden considerations stressed in [my 1995 textbook]. [My] approach reveals the tendency of modern public finance to focus on issues that can be dealt with neatly with microeconomic theory, while [Lutz’s] approach shows a striving to find practical principles for government behavior, without caring very much whether they can be derived from some underlying theoretical framework. (Rosen 1997, 6)

In fact, it is doubtful whether Rosen’s approach proves superior to that of Lutz. The latter method seems more relevant to an explanation of the facts and trends of public debt over recent decades; the moral character of debt-issuing governments surely is arguable amid the imposition of large public debt burdens, the perpetuation of fiscal illusion, the potential exploitation of future generations as fiscal commons, and repeated debt defaults. Moreover, many highly-leveraged governments have seemed inattentive or dismissive about the realities of the private sector’s taxable limits and/or debt-serving capacities. It is not clear why a preference for ever-more technical applications of game theory or microeconomic theory, or an ever-more abstruse parsing of Barro’s Ricardian equivalence thesis, can advance our understanding of the causes and consequences of public debt. To eschew “practical principles for government behavior” in the field of public debt is, perhaps, to invite the adoption of knowingly impractical methods.

The chapters on public credit and debt in Lutz (1936) begin with an illuminating discussion of the “nature and principles of public credit,” illustrated by its origin, evolution, and institutionalization, including its relation to the spread of democratic-
representative government, property rights, saving, and capital markets. (Lutz 1947, 711-733). Next, Lutz treats the “management of the public debt” (734-763), debt problems (764-796), state and local debts (797-824), and “the effects of public borrowing.” (825-847). Whereas Lutz devotes 14% of the pages in his textbook to deficit-spending and public debt, Rosen and Gayer (2009) devote less than 2%, and their limited treatment is not uncommon today, for another widely-used public-finance textbook (Gruber 2011) devotes less than 4% of its pages to public debt.

By the time Lutz treats public debt in the fourth and last edition of Public Finance (Lutz 1947), the full extent and implications of public borrowing amid the Great Depression and World War II are better known. Lutz is not pleased with the trend. In 1936 the U.S. federal debt was $34 billion, or 40% of GDP, but by 1946 it was $269 billion and 121% of GDP. In the 1947 edition of Public Finance Lutz devotes even more space to public debt (17% of all pages) than he had in the 1936 edition (14%), and in light of the impact of the Great Depression in the 1930s and U.S. involvement in World War II (1941-1945), he reassesses the nature and principles of public credit (527-544), the management of public debt (545-565), problems arising from federal debt and policies (566-598), state & local debt policies (599-620), the effects of public debt (621-632), and, in a section that did not appear in the 1936 edition, “the case for a balanced budget.” (682-703)

For Lutz, the “new economics” of Keynes was neither new nor true. “During the past ten years [1937-1947],” he writes in his 1947 preface, “various alien doctrines have
gained an increasing degree of acceptance” in the U.S., and although “they seem to be new,” in fact “they are really old and highly discredited doctrines,” for “since John Law [1671-1792], to go no farther back into history, there has been a succession of those whose stock in trade has been the same old nostrum – easy money.” According to Lutz, new labels on old bottles do not make for new or better content. “The essential theme of these doctrines,” he writes, “is statism, that dreadful thing for the removal of which from the earth we have fought two devastating wars. The proposals for using the fiscal powers to influence, or control, or direct the economy along some road laid out by the planners necessarily mean a despotic control over the fortunes and the destinies of all men. Acceptance of such a program involves the subordination of all other values and objectives to security,” and “in gaining security by such means we shall becomes prisoners, at large, of the state.” In contrast, Lutz writes, “the point of view expressed in this book is the exact opposite of that represented by these alien fiscal doctrines. Instead of presenting spending, taxing, and borrowing as the way to the abundant life, this book says, in substance, ‘There is no free lunch.’” (Lutz 1947, v) Thus amid the spread of what he calls “alien fiscal doctrines,” Lutz seeks to revive classical theories of public finance, including public debt, and in the process, offers an adage that was later to be made famous, in the 1970s, by Nobel laureate Milton Friedman.

Interestingly, Lutz (1947) does not attribute the spread of “alien fiscal doctrines” directly (or even indirectly) to John Maynard Keynes; he largely addresses the
arguments of Alvin Hansen (the “American Keynes”) but does not reference Keynes’s *General Theory* and cites him only once, on estimates of the spending multiplier (1947, 44). Yet Lutz cites De Vitti De Marco, whose 1936 book (*First Principles of Public Finance*), as we have seen, also influenced Buchanan and the public choice school. This corroborates our earlier interpretation that it was mostly the Keynesians – followers of Keynes, more than the man – who advanced the most open-ended interpretations of the supposed regenerative powers of an expansive state and unchecked deficit-spending.

In what might be interpreted as a veiled reference to Keynesians, Lutz complains that some economists and policy-makers are “exploiting the doctrine that public debt need not be repaid, except as convenient, which usually means never. Under this doctrine debt can be the means of creating larger future income. By selling government bonds to the banks, additional purchasing power is created without depriving the citizens of any part of their respective incomes. Thus the total national income, as expressed in dollars, is raised. If the troublesome matter of redeeming these bonds be dispensed with, the only burden involved in the increased debt is the taxation to pay the interest thereon.” (Lutz 1947, 531) Lutz rejects this theory, as did the classical school in the 18th century, when it rejected mercantilist-oriented arguments for an expanding public debt. For Lutz, writing in 1947, the U.S. in the 1930s “was in the grip of the experts in panaceas,” and of all the “spurious remedies” that were being peddled, “none
was more persistent than the idea that by working less, producing less, accumulating less, yet borrowing more, the country could become more prosperous.” (Lutz 1947, 609)

A political economy of public credit and debt is overt in Lutz. Unlimited democracy, he contends, is dangerously biased towards deficit-spending, public debt accumulation, and fiscal failure. “The chief reason for resorting to public loans,” he explains elsewhere, “is to obtain additional funds more easily than they could be secured through heavier taxes or higher charges for administrative services,” but the incentives to incur public debt or not differ depending on regime type. (Lutz 1947, 527) “Too often, democracies have been wrecked on the rocks of loose fiscal policy.”(Lutz 1945, 114) Unlike autocracies, representative governments must be concerned not to offend voters; pressures exist not only to spend for voters’ benefit, but also to fund outlays by loans, which are voluntary, instead of by taxes, which are compulsory. In democracy, the financing mix that feels less burdensome or oppressive to the electorate will be more welcomed and pursued by political elites. This anticipates Buchanan.

Neither autocracies nor democracies have commendable track records on public debt, Lutz says; he implies that a happy medium is required for fiscal integrity and sustainability – a representative but constitutionally-limited federal republic. To the extent a representative state is constitutionally-limited (neither an autocracy nor a pure, unlimited democracy), it is effectively precluded from exercising power arbitrarily or punitively; it will more likely abide the rule of law, respect contracts, and be credible in
the eyes of the public and public creditors. “Public credit,” Lutz maintains, “means a pledging of the good faith and the resources of the whole public for the repayment of debt incurred on their behalf,” and this “could not emerge” until the world had enjoyed some “growth of constitutionalism, whereby the people gained some degree of control over the public purse.”(527) This began in earnest with Britain’s Glorious Revolution and bill of rights (1688), continued through the establishment of the U.S. Constitution and bill of rights (1787-1791), and culminated in the democratic revolutions which overthrew most remaining European monarchs in the 1840s. “The rise of public credit is therefore contemporaneous with modern constitutionalism.”(Lutz 1947, 528) This constitutionally-limited democracy benefits public credit; limitless democracy does not.

Just government, for Lutz, also fosters confidence and savings, thus a pool of liquid capital from which the state can more easily borrow; the same state that fosters ample pools of saving (hence credit) tends also to deploy public credit with care and credibility. But as constitutional restrictions on the domain of majority rule wanes, as Lutz believes occurred ruling the progressive era (1900-1920), so do legal-fiscal-monetary restraints on government, and with these, remaining vestiges of fiscal responsibility and integrity. In its wake arrives what Lutz calls “the new fiscal thesis [of the Keynesians],” in the 1930s, which “is the more dangerous because it would use the public debt as the cushion and shock absorber against the rigidities that have been embedded in the economic system by group pressures, special legislation, and the reluctance of everyone
to face unpleasant facts.” “The citizens are being conditioned to accept the idea that there is to be no debt reduction, by various arguments designed to demonstrate the advantage and benefit of a large public debt.” (Lutz 1945, 117) Protecting over-paid but politically-active labor union members, public policy discourages microeconomic wage-rate cuts as a cure for mass unemployment, in favor of an unrelated macroeconomic expansion of deficit-spending. Lutz’s analysis presages the public choice analysis of rent-seeking; as pressure-groups become more influential, spending and tax breaks become more excessive, and the default position becomes deficit-spending.

Lutz also notes that when recessions occur in populist settings, the insistence by economists and policymakers on strict budget balance is seen as morally insensitive, while a lenient policy of deficit-spending is viewed as compassionate. “The situation which is most often brought in as being one involving a greater evil than a deficit,” he notes, “is unemployment,” so “advocates of a balanced budget as the regular practice are denounced as stony-hearted Tories who are utterly indifferent to the suffering and distress of those who are without work or income,” and “increases of debt for the purpose of providing relief to those without jobs [are] hailed as the acme of justice and humanitarianism.” (Lutz 1947, 696) Unrestrained democratic rule is biased toward deficit-spending, and the popular fear so common to contractions intensifies the bias.

Yet the main threat to fiscal balance and integrity in democratic settings, Lutz argues (528-529), is the tendency of politicians to pander to popular passions and to
mask the true burden of government (measured by its total spending, which must be
drawn from private incomes and wealth) by tapping the least onerous funding methods.
If, by borrowing relatively more, and taxing relatively less, a burgeoning state can divert
public attention away from the true size, scope and cost of its operations, it can grow
excessively and perpetually, even relative to national income, and even to the point
where public finances are no longer truly sustainable, and government resorts to ever-
more compulsory funding options (or debt defaults), such that free government itself is
lost. Even political independence is risked if a government comes to rely too much on
foreigners creditors (especially if they are foreign sovereigns or even semi-sovereign
international lending agencies). Lutz contends that the Great Depression of the 1930s
involved far too much public borrowing: “credit was freely, even wastefully used in that
period and there was no disposition on the part of [the U.S] Congress to consider
carefully the purposes to which the funds so obtained were to be devoted.”(529) Even
Keenys had described deficit-spending as “wasteful,” but he endorsed the waste on the
grounds that there was already an aggregate over-supply (“glut”) of savings and output.

Contemporary public choice analysis deploys the principle of “fiscal illusion,”
which holds that the true burden of government is disguised by the means of finance. As
we have seen, “fiscal illusion” is first suggested by Adams (1895, 22), who writes that
“the public servant can veil the true meaning of his acts” and the true cost of
government “by the free use of public credit.” The principle is also presaged in Lutz
(1947), who writes of deficit-spending as a “veil” covering the eyes of unsuspecting voters: “the ostensible purposes [of deficit-spending in the 1930s] were provision of relief and promotion of economic recovery,” but recovery in that decade proved elusive, because other motives – less public-spirited than was seen at the time – were operative: “public servants were able to veil the true meaning of their acts,” namely, a desire to “embark on great enterprises, including vast and ambitious schemes of social reform, without having to touch the pockets of the voters through taxes.”(529) Here Lutz uses nearly the same phrasing as appeared in a progressive’s work a half-century earlier, in warning that “popular attention cannot be drawn to public acts, except [as] they touch the pockets of the voters through an increase of taxes (Adams 1895, 22). Lutz elaborates:

During [the 1930s] the doctrine emerged that the manipulation of public credit was a proper and necessary application of fiscal policy and that no harm could be done by an indefinite expansion of debt. This is equivalent to saying that no harm can be done to the democratic system by permitting the government indefinitely to administer affairs independently by those who must finally settle the account. By no stretch of the imagination is it conceivable that the American people would have sanctioned the [government] spending of the 1930s had it been financed through taxation. Public credit prevented the maintenance of that scrutiny of expenditures which is essential to popular control over the purse. There was, therefore, a surrender of same part or element of that control, and to that degree a failure during these years to realize complete self-government. (Lutz 1947, 529)

Like Alexander Hamilton, Lutz is neither an optimist or pessimist about public debt, but a realist; contextual analysis and careful qualifications are important, for him, and he does not deny that government can provide necessary and valuable services;
what matters most, he stresses, at least on the question of the burden and effects of public debt, is the uses to which borrowed funds are devoted. Below we examine, in turn, Lutz’s views on the purpose and potential productiveness of public debt, on the validity of the private-public analogy, on the effects of public debt, the burden of public debt, the limits of public debt, and the usual means by which excessive public debt is handled (i.e., by conversion, repudiation, monetization, repression, and inflation).

As for the purpose, use, and possible productiveness of public debt, Lutz finds that “writers on public finance and the statesman in charge of national finances have been divided into opposing camps on this question of the economic usefulness of public credit.” (Lutz 1947, 536) On the one side, Smith, Ricardo, Say and Gladstone, taking the classical position, deny that any public borrowing can prove productive; they “opposed the use of public credit on the ground that it led to extravagance, encouraged resort to war, and induced generally disadvantageous economic conditions for the nation which employed it.” On the other side stood “Dietzel and various more recent German authorities who approve of the use of credit for financing all extraordinary expenditure on the ground that the state is part of the immaterial capital of society and that any unusual outlay in its service is in the nature of an investment. In this view [public] loans become a normal feature of the finances of the progressive state, and are to be regarded as both just and beneficial.” (Lutz 1947, 536-537) Yet “none of these extreme views can be
accepted,” according to Lutz, for “the usefulness of the loan depends on the usefulness of the purpose to which it is devoted.” He continues:

The true function of public credit is to serve as a supplement to the current revenues under certain conditions. . . . [The] public loan is proper or not, according to the circumstances that give rise to its use. Credit is the handmaiden of taxation, never its peer as a financial resource. It is a useful and important device for meeting financial burdens that are too great for the immediate capacity of the revenue system, or which are of such a nature as to warrant equalization of the load over a period of time. Unfortunately, the motive back of its use sometimes is the desire to evade the necessity of immediate taxation [because borrowing] looks like an easier way to pay the bills. The line between legitimate equalization of burden and improper evasion of the cost is not always easily drawn, and many specious arguments can always be found to prove that the thing which the community wants to do is the wise and necessary thing to do. . . . Politicians are usually fairly clever in gauging the popular inclination, and they would be the first to realize the practical unwisdom of increasing taxes as compared with the (temporarily) easier method of loans. [But] those who dance to the music should liberally contribute to the fiddler. (Lutz 1947, 537)

So for Lutz public borrowing is legitimate only when it pays for “an unforeseen emergency,” defined as a temporary period of unexpectedly high spending, when tax-raising invariably proves tardy, disruptive, futile or oppressive. As an alternative to borrowing, there is no need to run perpetual surpluses and accumulate a reserve fund to be tapped in such emergencies, because it will be prone to dissipation by excessive spending in normal times; by the same argument even some fiscal conservatives contend that chronic deficits will restrain growth in state spending; but “the regular recurrence of a deficit in the ordinary revenues cannot be met indefinitely by means of borrowing. Such deficits promptly lose their emergency character.” For Lutz, “if the expenditures
are not kept down to the revenues, then the latter must be increased,” and “[if] the shortage become habitual it is an indication that more revenue must be obtained.”

Borrowing to meet habitual deficits is merely “the use of public credit to pay current expenses,” (Lutz 1947, 538) and such a policy is “suicidal,” because it amounts to eating the seed corn. Thus, beyond the case of genuine emergencies “we have no valid basis on which to rationalize the existing public debt as beneficent.” On the contrary “it should be recognized as a serious problem,” so “instead of adding to it, even for such purposes of such primary importance as the relief of unemployment, we should plan to deal with this and other problems in ways that will avoid further debt increase.”

Incurring debt is only the “apparently easy way” of meeting emergencies, whether real or imagined, but these are best handled inside the budget, without incurring new public debt, “and this, in the long run, will really be the easy way.” (Lutz 1947, 703)

Unlike most theorists, Lutz is careful to distinguish between public credit and public debt, where the former pertains to a state’s capacity to borrow, while the latter pertains to its actual borrowing. The first is immaterial and potentially ephemeral, while the latter is known and explicit. The gap between public credit and public debt is available-but-unused borrowing capacity. Like the classical economists before him and the public choice economists after him, yet unlike the mercantilist and Keynesians, Lutz believes there are limits to any state’s public credit (hence debt); it is not infinitely expandable but depends on an economy’s taxable capacity (which is finite). A modern
state may have an unlimited power to pay its debts in fast-depreciating paper money, but that is a mere pretended repayment, a (barely) disguised default. Important for Lutz is the purpose for which borrowed funds are deployed, and that they are administered efficiently. He denies that the issuance of debt creates net new wealth: “In considering the appropriate use of public credit,” he writes, “it does not mean a direct creation of wealth,” and the appropriateness of a loan depends on how its proceeds are used: “[T]he effect of assembling a considerable aggregate of purchasing power under government control by means of a public loan may be beneficial or otherwise.” (Lutz 1947, 536) This is the realist position on public credit and debt, as Lutz elaborates:

If the expenditure of the government loan results in a diversion of commodities and labor into wasteful and unproductive uses, there can be no addition thereby to the community capital, but rather a loss of wealth and productive power. If the public funds that are provided by means of a loan are spent in acquiring capital goods for the operation of some commercial enterprise, there may be an equivalent to the capital creation which might have occurred had the funds remained in private hands. Some part of the proceeds of public loans may be spent in the construction of public works and public buildings, which are socially advantageous and productive, though they yield no return on the outlay. Loans of this character contribute to the stock of social wealth, and within limits, sufficient social advantage may be realized from such debts as clearly to justify their burden. . . . Whether the public loan increases the community’s wealth or not depends entirely on the way in which the proceeds are spent. (Lutz 1947, 536)

As to “the question of the use of public credit to finance those projects and activities that are of general social advantage, but which do not afford any opportunity for a direct financial return” – such as highways, education, sanitation, recreation, and public philanthropy – Lutz believes “no categorical answer can be given.” But it can be
said that “it is suicidal for a government to create permanent or long-term debts for the payment of current expenses.” (Lutz 1947, 539) Interestingly, this was also Keynes’s view of the purpose of public borrowing, although not of most subsequent Keynesians.

Deficit-spending in wartime is one thing, according to Lutz, and mainly justified, but in peacetime, it is dangerous and potentially self-defeating, inimical to confidence and recovery. “Prior to the depression of the 1930s, war had been the principal reason for [U.S.] federal emergency borrowing,” Lutz writes, but “the depression [of the 1930s] compelled both national and local governments to borrow in violation of the ordinary canons of good loan policy. The shrinkage of revenues and the obligation to provide relief for large numbers of unemployed made borrowing the only available source of expendable funds in view of the restricted tax methods of the time. Loan receipts were used very generally for current operating expenses, a fact that should have persuaded both national and local governments to exercise restraint upon the volume of borrowing.” However, Lutz complains, “the country was in the grip of the experts in panaceas during these years, and of all the spurious remedies, none was more persistent than the idea that by working less, producing less, accumulating less, yet borrowing more, the country could become more prosperous.” (Lutz 1947, 609) The misguided “experts” he implies, were the Keynesians.

For Lutz, the fundamental transformation from a system of sound to unsound public finance (and debt) occurred during World War I, before Keynes himself became
so influential. “The [U.S.] federal debt situation as of June 30, 1914, on the eve of the first World War,” he wrote, “was very favorable,” because “the total interest-bearing debt was relatively small, the interest rate was moderate, and the maturities offered no difficulties for the future.” (Lutz 1947, 566) “The transformation in the [U.S.] federal debt situation between 1914 and 1919 was great enough to shock anyone who could appreciate the essentials of sound financial policy.” In 1920 federal interest expense was higher than the entire principal of the U.S. national debt in 1914. (Lutz 1947, 568)

Yet it is notable that during the prosperous 1920s, when the first two editions of Lutz’s public finance text appeared (1924, 1929), the U.S. national debt was being reduced, along with federal tax rates and spending, and no case was being made, by any leading economists, for deficit-spending as an economic stimulant. Lutz initially offered his critique of 1930s deficit-spending in 1938, only two years after the publication of Keynes’s General Theory (1936). Writing in the Harvard Business Review on “federal depression financing and its consequences,” Lutz argued that policymakers should realize that not only higher taxes but higher debts can deter economic recovery, that in the U.S., the federal “loan policy would retard recovery fully as much as more taxation would have done” (Lutz 1938, 129) even with underemployed resources and supposedly excessive savings. The real burden of government is its spending, he contends, regardless of how it is financed (as did Ricardo), and this burden cannot be effectively mitigated simply because there is a less-than-usual capacity utilization rate.
Lutz believes there should have been public spending restraint in the 1930s, greater reliance on taxes than public debt to fund outlays, and flexible adjustments to wage rates (downward) to clear the labor market and avoid mass unemployment (Lutz 1947, 686). Instead, spending, taxes and debt sky-rocketed, while wage rates remained elevated (under official government policy), all of which made things worse than necessary.

As for debt-funded outlays in the 1930s, Lutz contends that “the loan method of providing funds seldom promotes prudence.(Lutz 1938, 130) Fighting an economic depression is not akin to fighting a foe in war; it is not true that budget deficits” are “equally legitimate in both cases,” and not even in war, because “it is by no means clear that every war should be financed by borrowing.” Debt-financed war expenditures only makes wars more likely and more lengthy, such that “the pernicious practice has done incalculable harm in the past hundred fifty years.” Indeed, Lutz argues, “the device of public credit has been quite as responsible for endangering the peace of the world as the invention of gunpowder.” When war occurs, loan finance is certainly permissible, Lutz concedes, but only after “every effort is made to tax the people to the limit.”(133)

In sum, Lutz believes that the U.S. federal debt incurred between 1930 and 1938 (more than a doubling, from $17 billion to $37 billion) “has not been entirely a clear gain,” because of the tax burden it implies, both for now and the future, and while he concedes that interest payments also flow into pockets (of public bondholders), he insists that much dead-weight loss results from inefficient and wasteful financial
administration. Lutz also worries that much of the newly-issued debt was sold to banks instead of individuals, and during a period of severely-depressed demand for private credit, so Treasury yields are artificially low; when market rates eventually rise, the value of Treasury securities will plummet and refunding of maturing Treasury debt will have to occur at successively higher (and generally unaffordable) interest rates. As if he is describing market conditions in 2012, not 1938, Lutz writes that “the government has become committed to the maintenance of easy money, low interest rates, and low investment yield, and to the manipulation of the market in order to preserve this status” of over-indebtedness, and to “a singularly inconsistent policy with respect to banking reserves and the credit inflation which excess reserves tend to encourage.” (Lutz 1938, 134) Just as deficit-finance and the money-creation bias that accompanies it render wars likelier and lengthier, they also lead to a permanently-bloated sovereign:

[Public] credit inflation is so easy, so painless for all, and it produces such a soothing sense of unlimited financial resources, that it has lulled all but the very few into a false sense of security. One of the worst results of the manner in which the depression requirements have been financed is the permanent effect of this policy on the level of public expenditures. The history of the federal finances reveals that after every great emergency expansion, it has been impossible ever to reduce the total expenditure to anything like the earlier amount. Heretofore, war has been the chief national emergency . . . [but now] the lavish depression spending has had the same effect. When the large deficit was decided upon, everyone supposed that it would be but temporary . . . Only a few realized that a temporary expansion of this magnitude would leave its permanent mark. In 2000 A.D. American taxpayers will still be feeling the effects of the “temporary” spending policy that was adopted in the 1930s. (Lutz 1938, 136)
Here we see Lutz making the novel claim that deficit-spending itself facilitates excessive government spending, not merely the reverse (and more obvious) claim that excessive spending generates budget deficits and thus a rising public debt. There may exist, he suggests, a vicious fiscal spiral, in which excessive spending cause budget deficits, but the relative ease of funding such deficits exerts no pressure to restrain outlays (or raise taxes), as needed to resume budget balance.

As to the supposed analogy between private debtors and public debtors, Lutz believes (unlike Keynesians) that it is valid, which places him yet again in the camp of classical and public choice theorists. In the 1947 edition of his textbook, as in earlier editions, Lutz assumes a tight analogy between private and public credit, and believes states should operate their finances in accord with the same fiscal norms and rules as households. “Public and private credit are alike,” he insists, “in that they both depend upon the resources of the debtor, the promptness and certainty with which obligations are discharged, and a reputation that is free from any taint or suspicion of default, intentional or otherwise.” Indeed, he contends, “all credit is a mortgage or lien against future income, and its outstanding amount must be kept in such relation to that future income as to assure repayment without undue impairment of the capacity to meet the ordinary requirements of the future. Over-borrowing against future income means perpetual indebtedness and eventual bankruptcy.” (Lutz 1947, 530-531) “At all these points,” he argues, “there is a strong resemblance between the public and private
economy. Neither the government nor the individual can spend more than has come in, and the appearance of a deficit in either case compels resort to other devices for making ends meet. The possible choices for balancing income and outgo are much the same for the government and the individual.” (Lutz 1947, 532)

In public finance the options are few and well-known: spending can be curtailed, revenues or income can be increased, and/or debt may be incurred. But at root, says Lutz, “the principles underlying government credit are not different from those that apply generally. The similarities and contrasts . . . between the state and the individual as debtors do not reveal any important differences between public and private borrowing. In both cases the credit rating will depend on much the same factors.” (534) These are character, capacity and capital. “In the case of a government, character means the sense of honorable obligation on the part of the whole people with respect to meeting the terms of the contract,” and “only states of high character are willing to pay. Of course, an ability to pay is also crucial of debts are to be serviced, but that is a matter distinct from a willingness (or commitment, or intention) to pay; nevertheless, “governments of high character and integrity are also not myopic; they plan ahead and make sure they do not put themselves in a position of being perfectly willing to pay, yet unable to do so in fact.” (535-536) “Capacity means the good judgment of the administrative officers in determining between the proper and the improper uses of public credit.” (536)
For the state, the equivalent of capital or collateral, which the private debtor needs to back the loan, is “the resources of the state, which are, ultimately, the wealth and taxable capacity of the people.” (534) What explains the views of those who reject the analogy, and insist the state may play by different (and subjective) rules on credit and debt? It is, Lutz writes, “the modern public debt cult, with its teaching that public credit is an instrument of policy, and that the obligation incurred may be kept or disregarded according to the dictates of some broader aspects of policy.” Ultimately, this public debt cult “is responsible for the view that national debt is mysteriously different from the debt of private individuals or corporations.” (Lutz 1947, 702-703)

Lutz complains that some defenders of perpetual public debt argue that it is safe, because unlike private citizens or on-going businesses, “the state is eternal,” so “the lender need not, therefore, have the same hesitancy about an indefinite loan to the state as he might be justified in having when asked to loan for an indefinite period to a private debtor.” Perhaps, but leveraged states must beware of “the folly of relying on the course of [currency] depreciation or upon the progressive increase of the national wealth, as the means of lightening the burden of the public debt.” (Lutz 1947, 555) He writes, of course, in the time of the gold standard, when resort to inflation is restricted.

We have stressed that Lutz is neither an optimist nor pessimist on public debt, but instead a realist who always views the matter contextually, and this shows also in his discussion of the private-public analogy. Pushing back not only against Keynesians
who deny any part of it, but also against the classical writers who presume the analogy to be perfect, and justification of hog-tying the state, Lutz contends that “there is a crucial difference that makes the private-public analogy entirely inapplicable,” for unlike private loans, public loans are legally unenforceable, and while states run bankruptcy courts, they are not subject to them. “Those who lend to sovereign governments,” says Lutz, “are helpless when it comes to collecting their loan unless the government is willing to pay, for they cannot use force, nor may they even sue in the courts to establish a judgment without the government’s consent,” and “consequently, the record that a government has established with respect to past debt obligations becomes a significant index of the national character. Every broken debt promise, whether in major or minor details of the contract, reflects the underlying popular attitude toward the debt obligation. National character is not a fixed quantum. Nations with poor debt records may improve, and those with good records may deteriorate. The attitude of one generation is not necessarily that of another.” (Lutz 1947, 535)

Lutz’s attention to issues of public morality and political economy, and the fact that each may change over time, has been criticized by Rosen (1997), as we have noted, yet such attention to ideological context is illuminating. “Public borrowing involves conflicts of group interest and prejudices so serious as to increase the difficulty of appraising correctly the national or community integrity,” Lutz observes (535), and whereas at times the public creditor is seen as “a progressive citizen and a great patriot,”
at other times he is but “a grasping money lender,” “a Shylock, an obstructor of progress.” (535) Obviously, the progressive patriot will more likely receive empathy and repayment, compared to the reception afforded the publicly-maligned, grasping and greedy money-lender. “Always, when the time for payment comes,” Lutz notes, “the investor [in public bonds] can be put in the wrong by being classed with the money changers,” and although most people claim to recognize the importance of keeping one’s promises and paying one’s debts, it is not always so with “the economic conflict represented by the public debtor-creditor relation,” for it is “one in which deep-seated prejudices are very easily aroused, and the appeal to this prejudice is a sure fire demagogic trick.” Such a policy is more likely “when there is some doubt about the underlying justification for the loan. If borrowing has been undertaken without a first-rate case for it, the fanning of class prejudices is a good way to shift the blame.” (535)

Lutz is also a realist in recognizing that sometimes budget deficits are best narrowed by tax hikes instead of by spending cuts. A democratic citizenry must be made to feel as much of the full brunt and cost of the government they elect as is possible. They should be under no illusion, Lutz holds, as to what they have wished (and voted) for; but for this reason the tax burden must also be broad, not narrow. This ensures that the public debtor acts more like the private creditor. Chronic deficit-spending especially signals the need for new tax increases, Lutz holds. “[T]he regular appearance of a deficit is the signal for revision of the revenue system,” although
“immediate readjustment is not always feasible,” and unlike individuals, who cannot easily or quickly increase their income in the face of high personal debt, “governments may accomplish [their goal of raising revenues] through the exercise of the sovereign power of taxation.” (533) At the same time, it is possible “that the tax burden is already so great as to make further heavy increase inadvisable.” (533-534) “The only practical basis of floating public loans is” “the presentation of the request for funds on strictly business principles. The greatest success in making loans will be achieved by those governments which present terms that are attractive to the investors,” for “as a borrower the government is competing with private industry for a share of the available surplus funds of the community,” so it must appeal to “the economic self-interest of the savers who are to provide the funds.” (Lutz 1947, 551)

Finally, for Lutz the private-public analogy holds in regards to creditworthiness and debt defaults. Given the many defaults on public debt, globally, from the start of World War I in 1914 until the end of World War II in 1945, “governments have abundantly shown that they are but little more dependable than private debtors with respect to the fundamental obligations of the debt contract.” (543-544)

As to the effects of public debt, what Lutz calls the “mechanistic aspects of public borrowing,” “the process results in the creation of a certain volume of assets for the financial community, since the government’s debt obligations constitute assets in the hands of its creditors. The process is also likely to involve [a] close relationship between
the Treasury and the banks, and it therefore touches at many points the problem of banking and credit policy. Moreover, its ramifications extend to the currency system, particularly when public debt obligations may be used to elicit or support credit and currency circulating media, or issued in a form designed to circulate as money, with legal tender power to liquidate private as well as public debts.” (Lutz 1947, 621) In one important sense, the significance and effect of public borrowing “lies in its relation to taxation,” for “it redistributes the tax burden in time, lessening it for the present and causing a subsequent increase for its debt service.” (Lutz 1947, 621)

Yet for Lutz, public borrowing ultimately and unavoidably impinges on private savings or entails some kind of untoward manipulation of the banking sector by government. “The funds that are obtained by public borrowing are drawn from the income or savings (i.e., past income) of the people, or they are created by manipulating the credit resources of the banking system.” (1947, 621-622) Whereas public borrowing of extant private savings constitutes a “diversion of purchasing power,” borrowing from banks involves a “net increase in purchasing power,” although he does not mean to imply that this is real purchasing power, since he adds that “such action is always inflationary,” it follows that “non-inflationary borrowing is the wiser and safer general rule.” (1947,622) It is true, he says, that credit expansions can help an economy recover from stagnation, but private credit stimulates in ways that public credit cannot: “the most beneficial results are realized when the credit expansion is generated by the private
economic forces,” not by public deficit-spending. Lutz contends that governments are prone to pursue inflationary borrowing (from the banks) because it is easier and cheaper than drawing on private savings. Unlike private credit expansions, where “the private demand for loan accommodation is the pace of private business,” the “force that creates the government demand is an unbalanced budget,” and “there is a steady credit expansion with no possibility of self-liquidation or contraction.” (1947, 626)

Government’s financial reliance on the banks, including its central bank, is also harmful, says Lutz, because it undermines the operational autonomy of each. In effect the Treasury compels banks, whether explicitly or implicitly, to serve the needs of a profligate government, which fosters profligacy and excessive risk-taking in banking itself. For Lutz, “sound finance requires that each member of this close affiliation [between Treasury and private banks] should be independent of the other. Those who advocate government ownership and monopoly of all banking and credit institutions and facilities overlook or disregard the importance of providing adequate checks and balances.” “A government monopoly of banking under treasury control would eliminate all chance of an independent check on treasury credit policy. The temptation for treasury manipulation of credit would be irresistible, and it would never be possible for anyone to know whether this manipulation was primarily inspired by the exigencies of government financing or by the requirements of the business situation.” “Instead of creating a government monopoly of credit, the Federal Reserve bank system should be
completely free of government influence, so far as concerns policy.” (1947, 627) Here Lutz foreshadows subsequent debate about whether central banks are independent of governments or instead their docile handmaidens (see Chapter 6, Section 6).

At this time Lutz must have had in mind the U.S. policy, begun in early 1942 due to war-time financing needs, whereby the Fed pledged to keep Treasury bill yields and bond yields at artificially-low levels (less than 1% and 3%, respectively), even amid what would become a nine-fold increase in federal debt, from 1941 to 1946. The policy ended and Fed independence was restored in 1951, by the “Treasury-Fed Accord.” (Hetzel and Leach, 2001). From 1941 to 1945 the Fed materially increased its holdings of Treasury securities, and through open-market operations off-loaded some of these holdings to banks in the private-sector, where reserves increased by 23% during the war years (1941-1945). Bank holdings of federal debt also skyrocketed, from just $17 billion (or 22% of total assets) in 1941 to $89 billion (or 56% of assets) in 1945. Whereas the 10-year U.S. T-Bond yield averaged just 2.4% during a war-time rise in debt and Federal Reserve interest-rate-targeting, it averaged 3.1% in the same period after the 1951 accord, when the U.S. federal debt was no longer growing so rapidly. Here Lutz anticipates subsequent debate about whether over-leveraged governments are tempted to engage in acts of “financial repression” to distribute their fast-rising debt at affordable rates.

Lutz also understands how excessive public debt issuance might have a deleterious effects on the basic value of money, which results in a general rise in prices
and the cost of living (inflation). War-time price controls had kept the U.S. CPI rate averaging just 5.2% p.a. from 1942 to 1945, but after controls were lifted the CPI rate averaged 11.4% in 1946-1947, and reached 20% in the year ending March 1947. Lutz held to a classical view of inflation as solely a monetary phenomenon, not the result of “cost-push,” “demand-pull,” or a supposed gap between potential and actual output. Yet unlike monetarists, he held to a quality (not quantity) theory of money; for Lutz, a currency like the dollar could hold its value, its real purchasing power, only when it was freely redeemable into a fixed weight of gold, as had been the case under the classical gold standard. The dollar was devalued by 60% in spring 1933, and ex ante fears of such a move, especially after FDR’s election in November 1932, caused widespread financial panic and bank runs in the subsequent six months. For Lutz, “public debt operations influence the volume of currency, and hence its value or purchasing power” (Lutz 1947, 628), especially when monetized by the Federal Reserve and banking system. “The value of the currency, or its purchasing power in terms of goods tends to be affected by the relative supply of purchasing power and of goods,” and “large-scale public borrowing is virtually certain to involve, directly or indirectly, and expansion of bank credit.” For Lutz, precisely this kind of “credit expansion is an inflationary force.” (Lutz 1947, 62).

At the same time, Lutz notes, inflation tends to diminishes the real value of debt, a revival of the classical (and even Keynesian) view that inflation helps debtors at the expense of creditors, while deflation does the reverse. In a government-induced,
inflationary credit expansion, conducted through the banking system, “the advance of prices registers the decline in the value of all forms of currency,” and “if the [public] debt increase is pushed far enough, the ensuing price inflation may attain proportions that would be tantamount to complete worthlessness of the existing currency, and likewise, of all obligations, public or private, that were payable in such currency.” (Lutz 1947, 629) It is undeniable, he observes (as did Keynes), that “a device for lightening the [public debt] burden is currency devaluation,” and while there exists historical cases of “complete destruction of debt through ruinous inflation,” partial debt destruction by inflation is more common,” and “resort to this device would be most likely in a period of depression” (like 1933), “which is normally characterized, among other things, by falling prices,” or deflation, in which there is an increase in the real debt burden. Currency devaluations, Lutz remarks (un-approvingly), have had “a long and disreputable record,” and have been “inaugurated [by governments] for the primary purpose of repudiating a part of the public debt,” which entails a gain to the taxpayer, at the expense of the bondholder.(Lutz 1947, 630)

As for the burden of public debt, Lutz generally acknowledges that a Ricardian equivalence argument is made and he suggests it is valid, as far as it goes (mathematically), but the argument is usually made by advocates of the heavy use of public debt, on the ground that taxes are just as burdensome, so it equally makes a case for placing fiscal primacy on taxes, not debt.(540) Lutz does not deny that the “argument
in favor of borrowing for capital outlays has certain validity, especially if it be granted that the community is one the members of which are keenly interested in increasing their investments, and are devoting all available income to this use,” but “strong, practical considerations” favor taxes over debt, because “the heavier taxes required to pay the interest and sinking fund charges are a certainty, while the gains which the taxpayers as a whole may realize” by investing themselves “are rather uncertain.” Indeed, when it comes to public debts, “it is highly improbable that the whole of their theoretical advantage will be realized,” and if so, “the [public] loan method [involves] a heavier burden in the end.” (Lutz 1947, 540)

Might public debt be perpetual and remain forever un-repaid? “The use of credit implies the creation of an obligation to repay or return something of value in the future,” Lutz holds, so a loan is “an incomplete transaction until the debt is repaid.” “It may seem superfluous to raise the question whether public debts should be redeemed,” he admits, but “it is reasonably correct to say that there is not much intention on the part of a country with large amounts of perpetual debt to redeem it.” In his view, nonetheless, “public debt should be redeemed sometime.” (Lutz 1947, 554) With a perpetual debt, “the annual burden of the debt is less, since there is no necessity of including sinking fund or amortization charges. It becomes easier, therefore, for a nation to carry a heavier load of debt in this form than would be otherwise possible.”
The case for perpetual public debt in the late 1940s, Lutz admits, derives from the fact that after two world wars and a decade-long economic depression, “modern debts have increased so rapidly as to cause a well-nigh unbearable charge for interest only. In other words, the absence of definite amortization plans has not kept the debt burden down – it has simply made it possible for the country to carry a larger amount of principal. If a government is obliged to plan for a debt repayment at a definite date, greater care will presumably be exercised in the volume of obligations which is assumed.” (Lutz 1947, 554) Attentive, as always to the motives of political leaders in unlimited democracies, Lutz notes how “debt redemption may always be postponed to a more convenient season,” and how this becomes “a powerful temptation to the administration in power to use the available money in other ways, or sometimes to cut away the surplus by reductions of taxes, and thus actually to postpone redemption.” (Lutz 1947, 554) “A general policy of [public debt] redemption appears desirable,” for it “puts an end to the tax burden on account of interest” and “public credit is thereby strengthened for any subsequent emergency.” “While a general policy of debt redemption is wise, it must be admitted that if a government’s financial situation is such that it can be accomplished only by the imposition of very severe, or very undesirable, taxes, the case becomes at best a choice of evils. These conditions are always relative; the decision must therefore rest on the comparative undesirability of taxes and of the debt.” (Lutz 1947, 556)
We have seen Lutz’s willingness to advocate tax increases, instead of spending reductions, to cure chronic deficits. But are these taxes not also a burden, and not merely for an unborn posterity, but for the living, here and now? Not necessarily, Lutz answers. “The objection that the taxes required for this purpose are merely an added burden is not valid. Taxes are always a burden and their imposition for debt repayment will never be a painless operation. Public credit is not indefinitely expansible, nor is it a boundless reservoir that may be drawn upon indefinitely without replenishment. Redemption of debt is the surest means of improving the public credit, and some policy looking to this end is a fundamental feature of every sound financial system.” “The advantage of a perpetual debt is illusory, since it leads gradually to an aggregate principal which cannot be redeemed and which, therefore, is truly a perpetual burden.” (Lutz 1947, 556)

That a perpetual public debt might become more burdensome over time is captured in Lutz’s unique conception of “debt pyramiding.” Periodic and opportunistic redemptions of public debt should always be undertaken, he argues, especially in peacetime, to avoid a dangerous pyramid. “While it is always advantageous that the national debt be redeemed as soon as possible, its refunding is less serious in that there is no approaching obligation to replace wasting tangible assets by borrowing again. Such loss or wastage as may have occurred in the case of federal borrowing happened once for all as the immediate war or depression expenses were paid. Aside from the question of aggregate cost, the main argument against undue delay in redeeming the
federal debt is the possibility that another serious emergency may appear before the
debt created to finance the last one has been redeemed. National debt pyramiding from
one great emergency to the next is “foolish and dangerous.” Indeed, “the European debt
burden is the fruit of national debt pyramiding under the fallacious notion that a
perpetual debt is cheaper.” (Lutz 1947, 610)

There is also most no discussion, in Lutz, about public debt as potentially an act
of inter-generational burden-shifting, unlike the deep concerns of public choice theorists
on the matter. But in discussing his preference that, unlike World War I, which had been
followed by demands for burdensome reparations, World War II should be followed by
aid and funds for reconstruction (the Marshall Plan), Lutz does address matters inter-
genational. With huge international public debts, he writes, “a whole generation of
persons not yet born must accept higher taxes and some restriction of consumption if
these commitments are to be fulfilled. Only a most gullible person would now believe
that these as-yet-unborn taxpayers and workers will bear such privations on our behalf
cheerfully and gratefully.” (Lutz 1947, 598) So this too contributes to more deficit-
spending. Indeed, “various factors have contributed to the readiness with which [deficit
spending] has been adopted. In the first place, taxation is currently burdensome,
whereas the full burden of debt becomes apparent only at a later time.”

Secondly, “there is the failure to recognize that unemployment is a symptom of
fundamental maladjustments [in the labor market, wage rates] and that spending to
relieve the symptom is no cure for the disease which produces it. Finally, the public debt has been rationalized and is exalted to the highest position of a beneficent and fructifying element in the economy. The remoteness of its burden has contributed greatly to belief in its supposed advantages. Having accepted in so large a degree this rationalization of the debt, resort to it becomes an acceptable means of escape from dealing with the more troublesome maladjustments which exist.” (Lutz 1947, 697)

In his chapter in defense of budget balance, in good times and bad, Lutz says his “primary purpose” is “to challenge the concept of the [public] debt as a beneficent element in the economy.” (Lutz 1947, 697) Unemployment must be cured, he insists, by microeconomic price adjustment (lower wage rates), and “government’s budget policy has no relation to this task.” “Budgetary deficits do not really provide employment,” for “they are, rather, a method of providing relief.” For Lutz, “the doctrines that have been recently popularized relative to the role of fiscal policy have been detrimental, both to a proper understanding of the central problem [of mass unemployment] and to the formation of correct measures.” (Lutz 1947, 698) He also rejects the view, which he attributes to Hansen, that “public debt is beneficial because it supplies a backlog of safe, highly liquid investment paper for financial institutions” and “an element of security to those with sizeable fortunes.” If such benefits exist, nevertheless they do not require a huge public debt, one whose growth exceeds that of other financial assets, and in fact, justifies only a moderate debt, for “with a huge debt there would be a far greater
likelihood of severe price changes in the event that holders of substantial amount sought
to liquidate,” and “liquidity achieved by the support of the central banks and the
Treasury is artificial and precarious.” “A huge [public] debt, by its very size, is a menace
to its own safety and security. These attributes rest on the productive capacity and
energy of the people,” according to Lutz, “since the government cannot, by an economic
legerdemain, support the value of its own debt. Even the open-market operations by
which an effort might be made to prevent serious price decline [i.e., yield increase]
involve further juggling with credit resources, or with the creation of fiat currency. A
huge debt will always present, also, the prospect of efforts to lighten the debt load by
further currency devaluation.” (Lutz 1947, 699)

Citing a 1942 excerpt from Alvin Hansen, to the effect that an internally-held
public debt is no net burden to the community, because the interest expense paid by
taxpayers is identical to the interest income received by public bondholders, Lutz says
this “correctly describes the transfer character of taxing and spending,” the plain fact
that “the money goes in and comes out,” but Hansen’s case wrongly infers “that the size
of the debt, and therefore the size of the transfer payments for debt service, are of no
consequence, which means the debt itself may as well be a large one as a small one.” But
this overlooks the fact that with greater debt and interest expense, the taxpayer’s burden
is intensified, and “if the taxes for debt service, or for other purposes, become heavy
enough to impair the incentives of those who must pay them, production, employment,
“and income are adversely affected,” and “the bad effects thus produced are by no means offset by the fact that other members of the community are receiving the funds paid out as interest on the public debt.” (Lutz 1947, 700)

In his critique of Lerner’s “functional finance,” Lutz (1945, 119) rejects the claim that “the debt is no burden since we owe it to ourselves,” because, in fact, it is not true that current taxpayers are not burdened, or not burdened less than bondholders are benefited, and at any rate, the analysis goes awry amid over-aggregation; “the unity of our common social interest does not go that far,” in Lutz’s view. By such presumed logic as “we owe it to ourselves,” no case can be made, either, “against any kind or degree of taxation whatever, for what is taken from some is at once paid to others. Hence taxation should be no burden to us since we are paying the taxes to ourselves.” (Lutz 1945, 119)

But Lerner would not agree; his logic does not hold; some are truly burdened, while others benefit, and the consequence, for Lutz, is a slow deadening of economic vitality.

As to the limits of public credit, we have seen Lutz hold that “public credit is not indefinitely expansible, nor is it a boundless reservoir that may be drawn upon indefinitely without replenishment.” (Lutz 1947, 556) The seemingly open-ended and infinite credit line of a government may easily and swiftly dissipate:

[The] community that has adopted the loan method of financing all of its permanent improvement projects will find that in time it has about used up its available credit resources. Such a community is thus placed at a distinct and possibly a very serious disadvantage whenever a genuine emergency does appear. Public credit is not an unlimited resource. Rather, it is a limited resource the supply of which should be conserved in the main for those circumstances
and requirements which cannot be fitted readily into the normal scheme of current expenditures and revenues. If it is used for defraying costs that should really be met out of current revenues, there will be no reserve protection against real emergencies. Since it is probably more costly to finance needed improvements in this way [by public borrowing], a community that yields to the temptation to do so is inclined, without realizing it, to live beyond its means. (Lutz 1947, 541)

Revisiting his several endorsements of the analogy between private and public borrowing, Lutz notes that “public, like private credit, is not credit at all unless there exists the ability to carry the loan, which means ability to pay interest and principal when due.” Moreover, “the normal long-run test of the ability to support [public] debt is the amount of public income that is available for the debt service over and above the requirements of the debtor unit for ordinary current expenditure,” and “naturally, this surplus of revenue is a variable quantity,” for “it depends on the taxable resources and on the willingness of the people to endure the taxes that may be required.” This contextual approach to analyzing public debt capacity is typical of the public debt realist. Moreover, Lutz is concerned with more than mere quantitative measures, which themselves are inexact and elusive. Psychology, confidence and expectations can be crucial “The capacity of any government to support its debt is, therefore, both economic and psychological,” and here he recounts his earlier discussion of how a “popular revolt against debt payment can be stirred up,” such that, “at bottom the subjective aspect of debt payment may be the determining one.” (Lutz 1947, 542)
Lutz rejects the views of William Beveridge and Nicholas Kaldor, that an expanding public debt is no real burden as long as interest expense on the debt is a steady proportion of national income. First, says Lutz, there is no guarantee that national income in the future will rise at its historic pace, and yet the debt and its servicing have already been incurred and pledged; national income could easily be curbed by punitive government policies. Second, the argument assumes interest rates will remain low (2% at the time), but that may not be possible amid rising inflation. Third, the account ignores the question of whether borrowed funds will be spent on consumption and transfers or instead on long-lived capital goods yielding service and income for decades to come, for the former will cause an unsustainable debt burden, while the latter is at least partially sustainable and assists growth of the national income upon which debt service depends. Even if borrowing is for traditional public infrastructure, the duration of the former should not exceed the expected life-span of the latter. (Lutz 1947, 700-702)

Since Lutz believes there are existential and even psychological limits to public credit and debt, he is more attuned to the many ways, including dishonorable ones, that states dispense with excessive debts. Again, Lutz exhibits a key element of the public choice approach, since he does not presume that states – especially those which are purely autocratic or purely democratic, hence largely devoid of meaningful constitutional limits – will act in the best interest of the public; depending on circumstances, they may act with the aim of predation, exploitation, or confiscation.
When public debt is excessive, states may resort to monetization, inflation, repudiation, and repression. Increasingly, Lutz discerns, such dishonorable and impractical means are unabashedly defended (as by Keynes). “So much has happened in recent years to overthrow various accepted notions regarding the proper attitude of governments toward their debt obligations as to cast doubt upon the validity of some of the old canons,” Lutz writes. Indeed, “some nations went cheerfully in default with respect to part or all of their public debt.” Lutz believes the economic depression of the 1930s has been used too much as an excuse for moral laxity in credit standards and practices. “The depression was held responsible, of course, although in fact the initial responsibility goes back to the fundamental disregard of the proper limitations on the use of public credit when borrowing rather than taxation was decided upon as the method of financing public expenditures. Essentially, therefore, the main defect was lack of [public credit] capacity.” (Lutz 1947, 543)

As mentioned, Lutz discusses the various ways over-indebted states seek to cope with their dilemma: conversion, repudiation, monetization, repression, and inflation. If a public debt cannot be repaid, “an undesirable and disagreeable option is default, and a still more disagreeable one is repudiation. But these are measures of desperation. The honorable alternative, for the public as for the private debtor who is unable to pay at maturity, is to seek an extension of the loan. In public financing such an extension of a matured debt is called **refunding**. Another procedures that involves changes of debt
terms is *conversion*. The two are not identical.” (Lutz 1947, 563) “Conversion means an adjustment in the burden of the interest on debt by some process of substitution.” (564) “Default is not repudiation, for it involves in no way the essential terms, but only the capacity of the debtor, which is a matter not always within his control. Repudiation is ordinarily not open to any debtor except sovereign governments, for any others who might attempt such a course would be liable to suits to compel observance of the contract terms. Sovereign states cannot be sued without their consent, and when any manner of debt repudiation is determined upon, steps are taken to withhold, or to withdraw, such consent.” (Lutz 1947, 590) “The national government is endowed with sovereign powers, and the validity of its debt obligation as a contract rests on the sovereign’s goodwill and beneficent intentions toward the creditors. Should such a government decide to repudiate its debt there is no protection and no recourse for the creditors.” (Lutz 1947, 607-608)

By debt monetization, the state increasingly resorts to selling its debt securities (obligations) not in the open market, where they may have lost some (or all) of their credibility and creditworthiness, but instead directly to its captive central bank (or indirectly, to closely-allied private banks). Public debts are effectively bought with the proceeds of money that is printed (or created electronically) *ex nihilo*. By 2012 this method had become a widespread norm, yet in 1947 Lutz could write of how “it has been proposed at various times that the Treasury Department be authorized to sell [its]
bonds directly to the Federal Reserve banks," and how “this proposal has been opposed and should never be adopted,” for “these banks are under fairly complete government influence, even domination,” so “they are in no position, therefore, to act independently, whether as critic of the contemplated fiscal action or in other ways.” Lutz prefers that the Federal Reserve “buy government bonds in the open market, as anyone is free to do,” not directly from the Treasury, via monetization. (Lutz 1947, 552)

In contrast to voluntary debt monetization, a government may simply compel its central or allied private banks to purchase and hold its public debt ("forced loans"), and/or ensure that they borrow at artificially-low interest rates, or simply print money (inflate) – *viz.*, engage in acts of “financial repression.” (see Chapter 6, Section 7) “The compulsory loan is a method of taking private wealth for public purposes,” Lutz writes, and “nominally it differs from taxation in that the state undertakes to repay the amount contributed, but an important form of the compulsory loan, the inconvertible legal tender demand note, is likely to be issued in such quantities, once the movement sets in, as to culminate finally in the utter worthlessness of the promise to pay.” (Lutz 1947, 550) Lutz believes such acts are morally dishonorable. “The provision of credit support by the use of force or compulsion cannot be condemned too severely. It means an unjust and inequitable distribution of the cost of government, since the creditors have no choice but to submit to terms in the determination of which they have had neither voice nor influence. If paper money is used, there is the additional danger of over-issue, with the
resultant inflation of prices and serious dislocation of economic interests. Once a
government has started on this slippery downward path there is the greatest difficulty in avoiding complete financial collapse.” (Lutz 1947, 550) “Compulsion, moreover, deprives the borrowing operation of all vestiges of a contract transaction and, indeed, of a credit transaction. It is fundamentally inconsistent to speak of a compulsory loan, since the basis of any credit transaction is confidence, and confidence flies out the window as force comes in at the door. The process is really one of commandeering private wealth for public purposes, and its real nature is not disguised by being clothed in the form of the loan.” (Lutz 1947, 551) Just as public borrowing entails fiscal illusion, whereby the true cost and burden of government spending is disguised and less-felt by the electorate than were it fully-taxed, so compulsory public debt financing and artificially-low interest rates disguise the true costs of the public borrowing.

That over-indebted states may resort to inflation, even hyper-inflation, is no mere theoretical claim, but a common historical occurrence, Lutz notes, especially in war time. “Obviously, the way to escape even the taxes [required to pay] for interest would be to force the banks to accept non-interest-bearing government bonds,” and “a still simpler way would be to compel the people to accept non-interest-bearing government notes or promises to pay,” which is, of course, purely “fiat” (decreed) paper money, as in the case of the “greenbacks” during the U.S. Civil War. “The inflationary effects of bonds stuffed into the banks is no different from the effects of using greenbacks.”(531) Unlike a
private debtor, or local government, a national government “is not so restricted in the exercise of the taxing power, except by the subjective resistance of the people,” but even when “there is strong opposition to taxation for debt payment, such a government has another alternative, in its control over the currency. A cheapening of the currency standard makes debt payment easier. While this is a partial repudiation, the government that engages in the practice usually faces a more disagreeable alternative if it attempts to collect taxes in sufficient volume to pay the debt on the standard by which it was contracted.” (Lutz 1947, 543) Lutz also notes that in modern times Keynesians overtly call for inflation to alleviate debt burdens.

In his chapter, “Debt, Taxation and Functional Finance,” in Guideposts to a Free Economy (1945), Lutz likens Abba Lerner’s notion of “functional finance,” and his plan to “boost the national income,” to a scheme to “lift ourselves by the bootstraps,” which is, of course, impossible (Lutz 1945, 114) Lutz asks “from whom will government borrow” when it is over-leveraged, after it has taxed the economy to its capacity, and is now resorting to a monetizing its debt and inflating its currency (i.e., its non-interest-bearing public debt? “As long as the public is willing to lend, it is said [by Lerner and the Keynesians] to make no difference how many zeros are added to the national debt,” for “if the public loses its taste for lending to the government its money, the government, it is said, can print the money to pay the interest and other public obligations. It is evidently assumed that the people will gladly accept this printing press money. But
suppose they will not? Will they be forced to take it? And at what value?” (Lutz 1945, 126) For Lutz, “fiat money” is “simply another form of the forced loan,” and Lerner’s functional finance is but a “bootstrap levitation” and “an abuse of public credit” made possible by “phony printing-press money.” (Lutz 1945, 128) Of course, Keynes himself had written similarly about inflation, in The Economic Consequences of the Peace (1920), of its capacity to redistribute wealth and make a nation appear to prosperous, however briefly, while “not one man in a million” could accurately diagnose its harmful effects. But unlike Lutz, Keynes approved of inflation as a means of public finance.

In 1933, Lutz notes, the U.S. federal government effectively defaulted on its debt, because it had promised to repay principal in a gold-redeemable dollar, but then devalued the dollar, in terms of gold, by 60%, and “concurrently with [this] devaluation Congress abrogated the gold clauses in all contracts, public and private.”(Lutz 1947, 591) Thus he concludes, “from the welter of default and repudiation in the history of public debt,” “certain emergent results seem clear” – viz., for any state “it is useless to pledge or to specify any particular kind or medium of debt payment (such as gold coin),” because “the best formal assurance that can be given” is a “pledge of the full faith and credit of the borrowing government,” and given the experience of a depression wedged between two world wars, “governmental obligations are, essentially, as speculative as any other type of investment security.”(Lutz 1947, 543)
Given Lutz’s general disdain for excessive public debt, we must not be surprised to find “the case for a balanced budget” as the penultimate chapter of Public Finance (1947). He is pleased to note how, in the 1930s, unlike U.S., Britain had small budget deficits, but this did not hurt its economy, which contracted, but by less than the U.S. economy. The big question, he asserts, is “whether the maintenance of a [budget] balance will be favorable or adverse to the beneficial functioning of the economy.” (1947, 683) Budget balance is economically beneficial, he says, and there is no inherent tendency, at least in a free market, to suffer involuntary or permanent underemployment of properly-price resources (materials, labor, or capital); moreover, should unemployment occur, its remedy is flexible microeconomic pricing (especially of wage rates), not consumptive and unsustainable rates of deficit spending or debt accumulation. Lutz denies that there is any “demonstrable causal connection between budget policy” and “variations in employment” (683), and rejects the claim that budget balance might (or a surplus) contribute to economic contractions. (684) He insists that busts are caused by preceding booms; the best way to prevent the latter is to preclude or mitigate the former.

Lutz also denies that maintaining budget balance during an economic depression will prolong it or hinder recovery, as long as balance is achieved by “transferring income or purchasing power from the citizens to the government with little or no net effect upon the aggregate.” (Lutz 1947, 685) Depression entails an “inability of government to reduce expenditures proportionately to the decrease of [national] income” (686), yet
Lutz would cure the resulting deficit by raising excise taxes (not income taxes, as was done in the U.S. in 1932, making matters worse for the economy and deficit). He concedes that “the taxes required for budgetary purposes would absorb a larger share of [national] income in a depression” (686), and he worries that such “encroachments on incentives may become serious” and “impair the standard of living,” but budget balance means government spending equals tax revenues, and this equality will help avoid “a net inroad on purchasing power by reason of taxes.” (686)

Lutz dismisses as mere “rationalization” the claim that public debt “will contribute to an expanding economy and to the attainment of full employment,” for “this position requires a more or less continuous increase of the debt, which obviously involves no effort at redemption.” In truth there is no “supposed advantage of an expanding debt.” (Lutz 1947, 700) Recall that Lutz, in 1947, is surrounded by advocates of what he calls “alien fiscal doctrines,” each convinced that deficit-spending and a vast “socialization of investment” could “stimulate” a moribund economy; on the contrary, he argues, “ordinary economic logic suggests that budget balance would be a wholesome and stimulating influence, particularly under the prospects which now confront the nation regarding the volume of debt and of debt service to be carried. The balanced budget would be an assurance against further inflationary policies and pressures,” “against such doubts as might otherwise develop regarding the future value of the debt and currency,” and “against the threat of extensive government competition
with private enterprise through the making of so-called ‘investments’ or otherwise.”
(Lutz 1947, 689)

Just as the public debt insights of Antonio Di Vitti De Marco are a fascinating precursor to subsequent public choice insights, so also are the views of Harley Lutz. Each is in the classical economic (and classical liberal) tradition, yet each also focuses more than did classical economists on the public morals and political economy of public credit and debt – as would subsequent scholars in public choice. Before proceeding to the public choice troika of Buchanan-Brennan-Wagner, the public debt theories of two other notable economists are worthy of brief investigation: Harold Moulton and Ludwig von Mises. Each offered early criticisms of the Keynesians’ “new philosophy of public debt” and “new economics.”

Harold Moulton (1883-1965), a professor of political economy at the University of Chicago for many years, and the first president of the Brookings Institution, made waves in Keynesian circles in the middle of World War II with the publication of The New Philosophy of Public Debt (1943), an indictment of unlimited deficit-spending and debt accumulation, as advanced by Lerner (“functional finance”) and Hansen (the “American Keynes” who had come to believe in “secular stagnation” and hence the need for a perpetually-expanding public debt). Keynes was still alive at the time (he died in 1946, three years after Moulton’s book appeared), and was pleased to see Moulton’s book criticized in a review by Wright (1943), a professor at the University of Virginia who
earlier argued for the relative non-burden of an internally-held public debt (Wright 1940), in the process of dismissing the argument in Gilbert et al (1938) that public debt could be increased indefinitely, without effective limit. Wright rejects that view, but, as well, the classical view that public debt is inherently a menace. In this regard Wright is more a realist on public debt than an optimist (like Lerner, Hansen, and Gilbert) or pessimist (like classical economists, Moulton, and Mises). According to Wright, the thought that public debt must be limited in the way a citizen must limit his own borrowing is “a mode of thought” that is “clearly inadequate,” yet “it is equally unwarranted to go to the opposite extreme and deny that an internally held debt can ever be a burden.” Thus “the statement that an internally held public debt imposes no economic burden on society is not entirely true. The burden has been enormously exaggerated, but it would be foolish to deny that it does not exist. (Wright 1940, 117, 129)

Moulton’s brief (93-page) study of the Keynesians’ “new philosophy of public debt” is notable because it is more philosophical-political than economic or technical; in this regard it is closer to a public choice approach. At a time when Keynesian theories and policies were still new (1943) and, for many economists (including the acolytes of Keynes) ambiguous, Moulton presents what he sees as a crystal-clear dichotomy, or as he describes it, the “two opposing philosophies with respect to public finance” which exist “in high government circles” – “the traditional view” versus “the new conception.”(Moulton 1943, 1) By his account, the traditional view of public finance and
public debt holds that “a continuously unbalanced budget and rapidly rising public debt
imperil the financial stability of the nation,” while the new conception insists that “a
huge public debt is a national asset rather than a liability,” and “continuous deficit-
spending is essential to the economic prosperity of the nation,” so “the conception of a
balanced budget belongs in the category of obsolete economic dogma.” (Moulton 1943,
1) The new philosophy of public debt “holds that public finance is really only a matter of
bookkeeping,” that “a rising debt has no adverse consequences, and that “without a
constantly increasing debt we cannot hope to have full employment and prosperity.”
(Moulton 1943, 5) Moulton, although a proponent of the welfare state, opposes the new
(Keynesian) philosophy of public debt, despite its advantage to welfare-state officials.

Even though, by 1943, U.S. federal budget deficits had appeared for thirteen
consecutive years, with an astounding 54% of all federal spending in those years
financed by federal borrowing, nevertheless Moulton believed the “traditional” view
was still held by top U.S. political-financial leaders – at the Treasury, the Federal
Reserve, Congress, and even by FDR at the White House. The pushers of the new debt
philosophy, he insisted, were ensconced at the National Resources Planning Board
(NRPB), and in certain leading universities. The NRPB had been established in 1933, as
part of FDR’s Public Works Administration; in 1934 it issued A Plan for Planning, and in
1939 was made part of the Executive Office of the President. Moulton cites various
NRPB reports and pamphlets which, in his words, suggest “that a substantial portion of
the government’s funds would permanently come from borrowing operations,” and if it ever becomes “difficult or impossible for the government to borrow,” it should resort to “the printing press method” of finance – or inflation. (Moulton 1943, 5) This was similar to the policy advice given by Lerner (1943) in his “functional finance.” But Moulton trains his main criticism at Hansen, who in the early 1940s was an advisor to the NRPB and the Federal Reserve. Moulton cites Hansen, from an NRPB pamphlet, insisting that “a public debt, internally held” “has none of the essential earmarks of a private debt,” that public debt is “an instrument of public policy,” “a means to control the national income,” and a tool “to regulate the distribution of income,” and further, from Hansen’s 1941 book, that “public expenditures financed by a continually rising public debt is essentially a conservative proposal.” (Moulton 1943, 7-8, emphasis in the original)

Moulton contends that the Keynesian debt optimists (he might say “enthusiasts,” or even zealots) are quite wrong, that in fact “a great and continuous growth of the public debt imperils the financial stability of the nation and undermines the very foundations of the economic system,” so the prospects of an ever-increasing debt “must be viewed with deep apprehension.” (Moulton 1943, 11). But are these bald assertions and ungrounded fears? How, exactly, does Moulton find public debt inflicting such harm? Like the Keynesians, Moulton advances the facile claim that “the vast increase in public [wartime] expenditures” from 1941 to 1943 “has mopped up unemployment and given us a great increases in production.” His only real complaint seems to be that the
spending was financed so disproportionately by borrowing. (18) Moulton denies Hansen’s “mature economy” thesis, and the view that perpetual deficit-spending is needed to fight “secular stagnation” or savings “gluts,” yet he never specifies the outer limits of public debt which he implies are so crucial to ensuring that the debt not “imperil” the financial system or “undermine” the economy; he also never explains how, precisely, public indebtedness inflicts the broad harm he so fears. Indeed, Moulton says he favors deficit-spending in periods of “depression and readjustment.” (Moulton 1943, 50), does not insist that budgets be balanced each year, and does not require that public debt be reduced in absolute terms, for “it is only necessary that the debt be kept under easy control,” meaning “well within revenue possibilities.” (Moulton 1843, 51-52)

Fixed as he is on the “philosophy” of public debt, Moulton provides no objective metrics to distinguish safe from dangerous levels (or proportions) of public debt. This weakens his over-wrought treatment. In 1943, even in the middle of war, U.S federal revenues were 13% of GDP. Might Moulton claim this to be the limit of “revenue possibilities?” Yet over the next two years U.S. tax revenues were 22% of GDP, and for the subsequent half-century, averaged 17% of GDP. In a sub-section of the book, titled “Limits to the Public Debt,” Moulton again declines to offer metrics, yet derides Hansen for wanting public debt “kept within safe limits,” for referencing the level of national income, types of taxation, and volumes of state investment and spending, and for suggesting “that the [public] debt [of the U.S.] might safely be double the national
income” – or 200% of GDP (Moulton 1943, 66), on the grounds that Britain reached that high in both 1818 and in 1923. Moulton dismisses Hansen’s empirical reference as “an alleged fact,” but indeed it is a fact. Britain’s public debt peaked at 261% of GDP in 1821, reached as high as 182% of GDP in 1923, and although it was only 157% of GDP when Moulton wrote in 1943, by 1947 it had reached 238% of GDP with nary a hint of default.

So Hansen is right – while Moulton only insists that “the safe limits of public debt cannot be gauged comparing the national income with the public debt alone.” (Moulton 1943, 67) Moulton names other factors, but again avoids debt metrics. His only specific forecast is that the U.S. will likely “drift toward the deep financial waters from which there is no return other than through repudiation in one form or another.” (Moulton 1943, 89) If this means explicit default on public debt, that had already occurred, in 1933, by means of FDR’s 60% devaluation of the U.S. dollar and his simultaneous abrogation of the gold clauses in all debt contracts; one might say it also happened later, in 1971, when the U.S. again devalued the dollar and left the Bretton Woods gold-exchange regime; since then there has been no explicit debt default or repudiation by the U.S., but the irredeemable dollar has lost 82% of its real value in terms of a basket of retail goods. There has been a massive implicit default.

In 1943, Moulton complains that Keynesians are “viewing the debt problem in isolation” and their analytical method “furnishes no guidance as to the safe limits of debt expansion” (67) but even if so, neither does Moulton incorporate adequate context.
At most he can only allude to “the basic fallacy in the new philosophy of public expenditure and debt,” namely, “the argument that all government expenditures, for whatever purpose, generate money income,” which, in the future, can help service public debt. (60) In the classical mode, Moulton suggests why this is a dubious claim, especially for spending on transfers and unemployment relief, and why it’s unlikely to be true even for most debt-financed spending on public capital and infrastructure.

To his credit, and much like Lutz, Moulton is careful to indicate how excessive levels of public indebtedness are revealed whenever states resort to deliberate monetary debasement and inflation to lessen their real debt burden (Moulton 1943, 74-79). “With unlimited [public] debt expansion,” he warns, “we cannot prevent inflation without the use of totalitarian methods of control.” (Moulton 1943, 88) While Keynes had declared, in the preface to the German edition of his General Theory (1936), that “the theory of output as a whole, which the following book purports to provide, is much more easily adapted to the conditions of a totalitarian state,” than to a free one, Moulton prefers a free state. Finally, he seems quite aware that democracy itself may be implicated in the public debt problem, for to spend with borrowed money more than with tax revenues is easier, he notes, and “the apparently easy way is, moreover, always the popular way.” (Moulton 1943, 13) Indeed, he concludes, “there is nothing in the long history of public finance which indicates that any government, and especially a democratic government, can be
depended upon to apply the brakes to credit expansion, when the proper moment has arrived.” (Moulton 1943, 79-80; emphasis added)

We next turn to Austrian free-market economist Ludwig von Mises (1881-1973), a public debt pessimist who incorporates more public choice elements in his analysis than is commonly recognized, and does so in the late 1940s, a few years in advance of the school’s ascendency, under the leadership of Buchanan. Given his voluminous writings, his classical liberalism, his occasional harsh attacks on Keynes’s ideas (Mises 1948), and deep mistrust of deficit-spending (and inflating) governments, there is surprisingly little attention to public debt in Mises’s works. His early studies focused on money and credit (Mises 1912, Mises 1923-1933), yet contain no sustained discussions of public debt, possibly because they preceded the Great Depression and World War II (thus their massive and sustained rates of deficit-spending).

Yet Mises includes a number of insightful passages on public debt in his most famous work, Human Action (1949). His main contention is that large public debts tend to redistribute wealth, not so much inter-generationally, but in the present, and from hard-working taxpayers to generally passive and idle public bondholders – and this harms both liberty and prosperity. Mises believes government borrowing competes unfairly for scarce pools of private saving (because the state’s taxing power entails a legalized, monopolistic command over resources), that public spending is largely consumptive, that even outlays for public capital projects are often dissipated in
bureaucracy and inefficiency. As such, public borrowing crowds out private saving and investment, which undermines capital accumulation, hence long-term economic growth. Public debts become excessive when states refuse either to curtail spending or raise tax revenues, then resort to monetary debasement (inflation), which aims to lower debtors’ burdens by surreptitiously robbing creditors. These views lie comfortably in the classical tradition, as well as in a public choice tradition marked by the premises that states are self-promoting. For Mises, too, governments spend, tax, borrow, regulate, and inflate for the sake of self-aggrandizement, not so as to promote the commonweal.

Mises does not mince words when he declares, in Human Action, that “long-term public and semi-public credit is a foreign and disturbing element in the structure of a market society (Mises 1949, 227), and worse, that there is “something basically vicious in all kinds of long-term government debts.” (Mises 1949, 540) The disturbing element and vice are not, he says, that public debts entail cost-shifting or unfair transfers of present burdens to future, unrepresented generations with no say in the matter, but because they tend to displace private borrowing, lending, investing and entrepreneurial risk-taking, all of which curbs wealth-creation. But the root problem, Mises says, is a political philosophy of state worship, and the lure of public debt securities, which fosters participation in statism and tyranny, instead of in capitalism and liberty. In such a philosophy, the state is interpreted as a “new deity of the dawning age of statolatry,” as an “eternal and superhuman institution beyond the reach of earthly frailties,” which
presents its bonds to the over-trusting citizen, as “an opportunity to put his wealth in safety and to enjoy a stable income secure against all vicissitudes.” In this way public debt, historically, “opened a way to free the individual from the necessity of risking and acquiring his wealth and his income anew each day in the capitalist market,” for “he who invested his funds in bonds issued by the government and its subdivisions was no longer subject to the inescapable laws of the market.” By the lure of public debt the saver and would-be creditor, who might otherwise have been a risk-taking financier willing to fund a productive entrepreneur, instead lent his capital to the state, and thereby “was secure,” “was safeguarded against the dangers of the competitive market in which losses are the penalty of inefficiency.” (Mises 1949, 225) This is the process, made possible by public debt, whereby an economy is transformed from one of risk-taking and vibrancy to one of security and stagnation:

[T]he eternal state [took the creditor-investor] under its wing and guaranteed him the undisturbed enjoyment of his funds. Henceforth his income no longer stemmed from the process of supplying the wants of the consumers in the best possible way, but from the taxes levied by the state apparatus of compulsion and coercion. [The creditor-investor] was no longer a servant of his fellow citizens, subject to their sovereignty; he was a partner of the government which ruled the people and exacted tribute from them. What the government paid in interest was less than what the market offered. But this difference was far outweighed by the unquestionable solvency of the debtor, the state whose revenue did not depend on satisfying the public, but on insisting on the payment of taxes. . . [The creditor-investor], no longer prepared to risk his hard-earned wealth, [comes to prefer] investment in [public debt] because [he wants] to be free from the law of the market. (Mises 1949, 225-226)
For Mises the state is largely a consumptive, redistributive entity that produces no net economic value – a view typical of the classical tradition. Whereas the classical view is that public debt harms the laborer, in Mises’s view it mainly harms the consumer. “There is in the social system of the market economy,” he writes, “no other means of acquiring wealth and of preserving it than successful service to the consumers,” but the state is typically incapable of rendering such service, and, moreover, it begins with no wealth of its own to trade or invest. Clearly, Mises does not equate “consumer” with “voter.”

Unlike the productive entrepreneur who borrows while serving the needs of his customers, the unproductive government borrower, says Mises, “is in a position to exact payments from its subjects and to borrow funds,” (Mises 1949, 226) and its deployment of those funds invariably leads not to net benefits but net burdens. “If the government uses the sums borrowed for investment in those lines in which they best serve the wants of consumers, and if it succeeds in these entrepreneurial activities in free and equal competition with all private entrepreneurs,” he writes, it acts like any businessman and “can pay interest because it has made surpluses.” But if, what is more likely, a government “invests [borrowed] funds unsuccessfully and no surplus results, or if it spends the money for current expenditures, the capital borrowed shrinks or disappears entirely, and no source is opened from which interest and principal could be paid.” (Mises 1949, 226) In the latter case “taxing the people is the only method available for
complying with the articles of the credit contract,” and now the real burden arises – and seems to be forwarded generationally. “In asking taxes for such payments [to service debt], the government makes the citizens answerable for money squandered in the past,” Mises writes, for “the taxes paid are not compensated by any present service rendered by the government’s apparatus.” In effect, “the government pays interest on capital which has been consumed and no longer exists,” so “the treasury is burdened with the unfortunate results of past policies” (Mises 1949, 226-227) – which means, in fact, that the truly burdened are those taxpayers compelled to replenish the treasury.

Although Mises insists public debts are burdensome only when the funds are spent consumptively, or for ordinary expenses, or on public capital projects that yield no surplus (profit), and although he also suggests such spending leaves a trailing burden of debt service on future taxpayers, he insists that the current generation is burdened too. Present and future generations alike suffer from a public-debt-financing of wasteful state spending, and Mises uses the case of deficit-spending in war to make his point:

A good case can be made out for short-term government debts under special conditions [as opposed to long-term, perpetual public debts]. Of course, the popular justification of war loans is nonsensical. All the materials needed for the conduct of a war must be provided by restriction of civilian consumption, by using up a part of the capital available, and by working harder. The whole burden of warring falls upon the living generation. The coming generations are only affected to the extent to which, on account of the war expenditure, they will inherit less from those now living than they would have if no war had been fought. Financing a war through loans does not shift the burden to the sons and grandson. It is merely a method of shifting the burden among the citizens [who are currently living]. (Mises 1949, 227)
Mises also rejects what he calls “the most popular” of the doctrines advanced by the public debt optimists, namely, that “a public debt is no burden because we owe it to ourselves.” In fact, he says, “the public debt embodies claims of people who have in the past entrusted funds to the government against all those who are daily [and presently] producing new wealth,” so public debt “burdens the producing strata for the benefit of another part of the people.” Moreover, if it were really true that “we owe it to ourselves,” “the wholesale obliteration of the public debt would be an innocuous operation, a mere act of bookkeeping and accountancy.” (Mises 1949, 228) In fact such an obliteration would be ruinous, not innocuous, precisely because a public debt is an asset to some (those who previously lent their capital, which was an asset) but effectively an asset which is a mortgage on the productive efforts of current taxpayers. Mises believes public debt only shifts net burdens to future generations when debt proceeds are not spent on remunerative infrastructure but instead on consumption or transfers. In his example of the unfunded social security system, Paul saves $100 in 1940 and pays it into the system, receiving a government pledge (bond) in return; the state immediately spends the $100 on ordinary outlays, instead of placing it in a trust and investing it for a return. No new capital is formed, so no future income source arises. Here, it seems, is a case of a real shift in burden to posterity. For Mises, “the government’s IOU is a check drawn upon future taxpayers,” and by 1970 “a certain Peter may have to fulfill the government’s promise, although he himself does not derive any benefit from the fact
that Paul in 1940 saved $100.” The scheme forwards a net burden to posterity. “The
truppery argument that the public debt is no burden because ‘we owe it to ourselves’ is
delusive,” Mises declares, for “the Pauls of 1940 do not owe it to themselves. It is the
Peters of 1970 who owe it to the Pauls of 1940. The whole system is the acme of the
short-run principle. The statesmen of 1940 solve their problems by shifting them to the
statesmen of 1970. On that date the statesman of 1940 will be dead or elder statesmen
glorying in their wonderful achievement, social security. The Santa Claus fables of the
welfare school are characterized by their complete failure to grasp capital,” and their
“implicit assumption that there is an abundant supply of capital goods.” (Mises 1949,
847-848) For Mises (and the classical tradition) “it is additional capital accumulation
alone that brings about technological improvement, rising wage rates, and a higher
standard of living,” and yet, “history does not provide an example of capital
accumulation brought about by government.” (Mises 1949, 851)

Clearly, this analysis strikes at the heart of Keynesian plans for a vast,
supposedly beneficial “socialization of investment” by the state. Here Mises
foreshadows future studies showing how unfunded, “pay-as-you-go” social insurance
schemes erode an economy’s capacity to save, invest, boost productivity, and prosper.

Mises seems to suggest that the system’s defects flow from democracy itself,
especially from its populism, and its electoral myopia, for under “democratic
government, the problem of capital preservation and accumulation of additional capital
become the main issue of political antagonism. There will be demagogues to contend that more could be dedicated to current consumption,” and “the various [political] parties will outbid one another in promising the voters more government spending and at the same time a reduction of all taxes which do not excessively burden the rich.” (Mises 1949, 849) Thus in 1949 Mises effectively foretells America’s fiscal dynamics and long-term trends over the next six decades (1950-2010): Keynesians and Democrats would enact more spending but not more tax revenues, while supply-siders and Republicans would enacted more tax-rate cuts but not spending cuts, with the result that too much spending and too little revenue would contribute jointly to widening deficits and rising debts. One might suspect that the main threat to national solvency comes not from disparate schools of economic thought or party affiliations, but from the unavoidable electoral pandering that seems central to unlimited democracy. But as we will see, Mises blames not parties or political systems, but false economic ideas and statist ideology. In this regard he lies outside the public choice perspective.

Mises begins by conceding that when governments were less democratic and more constitutionally-limited, as in the 19th century, public spending was lower relative to national income, money was redeemable in gold at a fixed exchange rate, and most citizens looked upon the state merely “as an institution whose operation required an expenditure of money which must be defrayed by taxes paid by the citizens.” But today – that is, by the mid-20th century – according to Mises, “the majority of citizens look
upon government as an agency dispensing benefits,” and “the state in their eyes is a spender, not a taker,” so now “the wage earners and the farmers expect to receive from the treasury more than they contribute to its revenues.” Here Mises echoes the views of Tocqueville, a century earlier, that unchecked democracy can lead to a “soft despotism” of widespread, popular dependency on government. By Mises’s account, “these popular tenets were rationalized and elevated to the rank of quasi-economic doctrine by Lord Keynes and his disciples,” but in truth, “spending and unbalanced budgets are merely symptoms for capital consumption,” and, indeed, “the total complex of [government] financial policies” in contemporary times “tends toward capital consumption.” (Mises 1949, 850) In Mises’s economic theory, then, Keynesian policies do not salvage a faltering free market but are, at root, anti-capital, hence inimical to technological gains, to rising wage rates, and to a higher living standard. For Mises, the root dilemma is the sway of false economic ideas and statist ideology; no legislative or institutional remedy (whether a balanced budget amendment or a gold standard) can mitigate such inexorable ideational influences; moreover, democrats and autocrats alike are “wise,” even “benevolent,” but only the latter is prone to selfish and harmful power-seeking. Mises, we see, is reluctant to indict democracy per se:

Many who are aware of the undesirable consequences of capital consumption are prone to believe that popular government is incompatible with sound financial policies. They fail to realize that not democracy as such is to be indicted, but the doctrines which aim at substituting the Santa Claus conception of government for the night watchman conception derided by [socialist Ferdinand] Lasalle [in 1862]. What determines the course of a nation’s economic policies is always the
economic ideas held by public opinion. No government, whether democratic or dictatorial, can free itself from the sway of the generally accepted ideology. Those advocating a restriction on the parliament’s prerogatives in budgeting and taxation issues or even a complete substitution of authoritarian government for representative government are blinded by the chimerical image of a perfect chief of state. This man, no less benevolent than wise, would be sincerely dedicated to the promotion of his subject’s lasting welfare. The real Führer, however, turns out to be a mortal man who first of all aims at the perpetuation of his own supremacy and that of his kin, his friends, and his party. As far as he may resort to unpopular measures, he does so for the sake of these objectives. (Mises 1949, 850)

Setting aside the origins of public debt burden, how is it typically shouldered or discharged, according to Mises? He notes that in the more liberal, capitalist societies of the 18th and 19th centuries, public debts were kept low and often reduced. “In the heyday of liberalism,” he recounts, “some Western nations really retired parts of their long-term debt by honest reimbursement,” but “the financial history of the last century [1849-1949],” in contrast, “shows a steady increase in the amount of public indebtedness,” to the point where “nobody believes that the states will eternally drag the burden of these interest payments.”(Mises 1949, 227) Credit means “to believe,” but over-indebted governments, Mises here implies, are ultimately less-believed, less-credible, less-creditworthy, yet all the while, due solely to their compulsory taxing power, nevertheless they are able to accumulate debts.

For Mises “it is obvious that sooner or later all these [public] debts will be liquidated in some way or other, but certainly not by payment of interest and principal according to the terms of the contract.” (Mises 1949, 227) He notes also that “it is
possible to free the producers of new wealth from this burden by collecting the taxes required for the payments exclusively from the [public] bondholders,” as some advise (see the capital levy), but “this means undisguised repudiation.” (Mises 1949, 228) He distinguishes a government policy of “debt abatement,” which seeks to favor debtors at the expense of creditors, and a policy of “debt aggravation,” which does the opposite and seeks to favor creditors at the expense of debtors. (Mises 1949, 783-784) Debt abatement is more common than debt aggravation, he says, just as modern government is more commonly a net debtor than a net creditor, and abatement occurs most commonly by a debasement of money, for “a government resorts to inflation in order to favor the debtors at the expense of the creditors.” The policy is self-defeating because eventually creditors realize the loss and begin demanding higher yields as compensation for a diminished future principal value. For Mises, inflation is “by no means a tool of constructive action,” indeed, “it is a bomb that destroys [capital] and can do nothing but destroy.” (Mises 1949, 785). Here it is obvious that despite Mises’s consternation over public debt, he still views it as a legitimate asset, a claim for capital willingly lent, a property right deserving protection; it is improper and foolish to destroy it.

As with De Viti De Marco and Lutz, Mises is suspicious of how unlimited democracies might foster chronic deficit-spending, permit the build-up of perpetual and unsustainable public debts, and then, by deep-seated prejudice, condone their repudiation. Democratic leaders are aware, he says that “public opinion has always been
biased against creditors,” for it “identifies creditors with the idle rich and debtors with the industrious poor. It abhors the former as ruthless exploiters and pities the latter as innocent victims of oppression. It considers government action designed to curtail the claims of the creditors as measures extremely beneficial to the immense majority at the expense of a small minority of hardboiled usurers.” To the extent political leaders in unlimited democracies cater to such prejudices, the assets and rights of creditors are at risk, and in democracy, “over all species of deferred payments hangs, like the sword of Damocles, the danger of government interference.” (Mises 1949, 540)

The bias Mises names is well known, to this day; in contemporary times, when credit sours, blame is assigned almost exclusively to those most harmed (those who lent money, now lost), the “predatory lenders,” and not to irresponsible, in some cases fraudulent and thus predatory borrowers. And if, in unlimited democracies, as Mises also suggests, governments seem less inclined to uphold the rule of law or to respect the sanctity of contract, especially in creditor-debtor relations, what must be the intensity and persistence of this inclination when government is also the system’s biggest debtor? Is it not in the interest of the over-indebted yet constitutionally-unlimited state to relieve itself of its debt burdens by exploiting popular prejudices and repudiating, whether in whole or in part, what it owes public creditors? As Mises puts it, today “the masses are unwittingly attacking their own particular interests” and as such, “no kind of investment is safe against the political dangers of anti-capitalist measures.”(Mises 1949,
Yet as we have also seen, Mises, intellectual refugee from European autocracy (and in Germany and Austria, dictatorships in the wake of parliamentary voting in open, free elections), is reluctant to attribute fiscal folly to democracy \textit{per se}. “Not democracy as such is to be indicted,” he insists, but the “Santa Claus conception of government,” that is, of the official “free lunch” (per Lutz), and the “quasi-economic doctrine” of Keynes and his acolytes. (Mises 1949, 850)

While the public choice perspective embraces Mises’s latter thought (regarding Keynesian ideas and their influence on public finance), it generally denies his former thought (regarding democracy and its influence on public finance), a distinction that is obvious upon a reading of Buchanan and Wagner’s \textit{Democracy in Deficit: The Political Legacy of Lord Keynes} (1977), of the volume edited by Buchanan, Rowley, and Tollison, titled \textit{Deficits} (1987), and of the most recent contributions, notably by Brennan (2012) and Lee (2012).

Much like Lutz and Mises, public choice scholars since the 1950s have tended to indict Keynesian theories for modern-day fiscal profligacy; but only like Lutz have they indicted both Keynesian theory and democratic theory. Mises is of mixed premises regarding democracy and profligacy, sometimes indicting popular rule, at other times exonerating it. A recent and succinct public choice view of the U.S. fiscal state is given by Dwight Lee, in a synthesis of prevailing economic theory and political practice. “[E]ven if Keynesian remedies could be implemented in a timely manner,” Lee writes,
“there are other serious problems undermining Keynesian hopes for moderating the
decline, duration, and frequency of economic downturns.” Primary among these
problems is that “Keynesian prescriptions are filtered through a political process being
driven by many competing agendas, of which balanced growth is only one,” and
secondarily, “Keynesian economics and the political process are almost entirely focused
on short-run demand-side concerns while largely ignoring the long-run importance of
economic productivity,” resulting in “a political dynamic that has increasingly turned
Keynesian economics into a prescription for fiscal irresponsibility that undermines
economic growth without promoting economic stability.” (Lee 2012, 474). This is
distinctive to the public choice approach: a realistic, not idyllic, treatment of the
intersection of politics and economics.

5.5 Contemporary Public Choice and Public Debt: Buchanan, Wagner & Brennan

Nobel laureate James Buchanan (1919 - ) is the pre-eminent scholar, not only in
public choice theory, but in the public choice theory of public debt. By itself public
choice theory is distinctive in its use of the axioms and tools of neo-classical economics
to investigate problems and puzzles in political science. Public choice assumes that all
people seek to maximize their preferences, whatever the source, and whether they
operate in the economic or political (or cultural) realm. Although public choice
originated as merely positive political theory, as a way to explain how politics works –

viz., how political elites, bureaucrats, and electorates act, and why they do so, depending
on institutional context – it also presents normative insights and convictions, and
defends certain policy prescriptions. Buchanan, for example, examines “Ricardian
equivalence” insights regarding the incidence of the public debt burden (Buchanan
1976), but also “the moral dimension” of public debt financing. (Buchanan 1985)

The traditional approach to political economy, originated by Adam Smith, and
intensified by the artificial construct of “economic man,” tended to bifurcate the world
between the economic and political, wherein economic actors were presumed to be
selfishly intent on maximizing their utility and profits, but prone to periodic “market
failure,” while political actors were assumed to be devoted selflessly to advancing the
“public interest” and the common good, and rarely, if ever, failing to do so. “Market
failure” was to be corrected by competent, benevolently-motivated statesmen. Public
choice, in contrast, assumes an integrated world of political-economic interchanges and
co-dependencies, with economic and political actors alike universally and primarily
(thought not exclusively) motivated by self-interest. Thus “government failure” is also
possible, with rent-seeking, log-rolling, gerrymandering, cost-shifting, and the fiscal
profligacy unique to unlimited democracy, where wealthy minorities and future
generations are exploited as “fiscal commons” (mere means to the ends of others).

Buchanan’s path-breaking scholarly effort in Public Principles of Public Debt: A
Defense and Restatement (1958) was the first, full-length theoretical treatment of public
debt in a half century or so – bearing in mind the equally-monumental work of H.C.
Adams, in Public Debts: An Essay in the Science of Finance (1895) – and no theoretical effort on public debt comparable to Buchanan’s has appeared in the half century or so since its publication. Public Principles of Public Debt spawned much debate and subsequent research (e.g., Ferguson et al 1964, Buchanan and Wagner 1977, Buchanan, Rowley, and Tollison 1987, Balkan and Greene 1990, Holcombe 1996, Jakee and Turner 2002, Munger 2004, Wagner 2007, Cullis and Jones 2009, Brennan 2012 and Wagner 2012). Over time, public choice insights have been incorporated in some of the leading textbooks of public finance; these insights are all the more applicable today, especially given vast increases in worldwide public debts since 2001.

A 1959 review of Buchanan’s Public Principles of Public Debt aptly characterized the work as an attempted “rehabilitation of classical debt theory.” (Peacock 1959) Buchanan’s focus is largely positive, not normative, and primarily on the economic effects (or “incidence”) of public debt, rather than on its political (or potential other) causes. Only later would Buchanan come to incorporate more normative aspects as well as realistic theories of political motivation and action, by which time deficit-spending would become chronic and public debt accumulation perpetual. Public choice insights are a subtext in Public Principles of Public Debt, but they become more explicit and appear in the forefront of an argument, two decades later, in Democracy in Deficit: The Political Legacy of Lord Keynes (Buchanan and Wagner 1977).
Consider the empirical context of Buchanan’s 1958 book. In the decade prior to *Public Principles of Public Debt*, the U.S. federal government had been running budget deficits only 30% of the time and had borrowed only 4% of total outlays, so its national debt declined from 94% of GDP to just 54%. In contrast, in the decade after Buchanan’s book appeared in 1958, the U.S. ran deficits 90% of the time and borrowed 6% of total outlays; the U.S. national debt declined further, in proportion to GDP, but less dramatically, from 54% to 38%. A half century before Buchanan’s book appeared, the U.S public debt was a mere 4% of GDP (1908), and it averaged just 10% of GDP in the century before that (1808-1908); a half-century after the book appeared, the U.S. public debt ratio reached 75% (2008).

In *Public Principles of Public Debt*, Buchanan reintroduces what he interprets as the classical theory of public debt, a theory of its nature, burden, and effects; it is a view he equates, unabashedly, with the “vulgar opinion” of the man on the street (a term of derision made by Keynesian defenders of unlimited debt). Buchanan then summarizes the “new orthodoxy” of public debt as promulgated (and practiced) by the Keynesians. Thereafter, he examines the methodology of debt analysis; the issue of whether (and to what extent) public debts unduly burden future generations; whether the analogy equating private-public debtors is valid; whether domestic-held (“internal”) public loans are any less burdensome than foreign-held (“external”) loans; the effects of public debt issued amid war versus economic depression; the impact of debt on inflation, and vice
versa; and general discussion of when, if ever, governments should borrow, whether, and by how much they should redeem or retire public debt, and whether deficit-spending is a valid means of ensuring economic stability and full employment.

If we may object at all to starting points, it may be to Buchanan’s belief that “the test of truth in public debt theory is the same as anywhere else, the consensus of informed and intellectually honest men.” (Buchanan 1958, 4) But surely, in the past, a mere “consensus” of opinion at any point in time, even of seemingly “scientific” opinion, has rarely immunized the public from wrong-headiness or falsehood. Indeed, much of the embrace of Keynesian debt theory in the 20th century may be attributed less to a steadfast devotion to truth than to a herd mentality that seeks to fit the “consensus,” whether of academia or Washington. Surely the proper standard of scientific truth is not agreement among minds but between our ideas and reality, between theory and practice. No “paradigm shifts” can occur if all participants remain committed myopically to the existing paradigm, else there would be no “new orthodoxy” to displace the old. Yet Buchanan is right to hope for “informed and intellectually honest men” who might exercise the requisite independence of judgment, as he did.

Buchanan launches Public Principles of Public Debt with a brief account of what he calls “the currently dominant theory of public debt,” or the “new orthodoxy,” which means, largely, the Keynesian view if deficit-spending and public debt accumulation. We may fairly say that the Keynesian view of public debt is at least as “dominant” today
(2012) as it was in 1958, as evidenced by the remarkable revival of Keynesian
promulgators during the vast run-up of public debt over the past dozen years. If
Keynesian debt theory were seen as obsolete, it would hardly be gaining strength amid a
record growth in public debt; after all, this is the theory which insists a public debt is no
real problem or real burden, even in large amounts, for we “owe it to ourselves,” and
further, it probably “stimulates” the economy. Buchanan, of course, disagrees. He seems
aware, in fact the “new orthodoxy” on public debt is not so new, in fact, but a throwback
to mercantilist conceptions, as Keynes himself openly acknowledged, in the penultimate
chapter of his *General Theory* (1936). Buchanan believes the young, over-excited
adherents of the “new economics,” in the 1940s, “should have realized that the same
arguments [had] been floating around since the early years of the 18th century,” and
thus that classical debt theorists were familiar with them and conversant with their
weaknesses and errors. (Buchanan 1958, 15) Ignorance of political economy’s doctrinal
history can undermine the validity of one’s theories and the wealth of one’s nation.

Buchanan believes that many of the confusions surrounding public debt reflect
its overly-homogenized conception. The term “public debt,” he declares, “is far too
generic a term.” Indeed, in a chapter devoted to “the methodology of debt theory”
(Buchanan 1958, 18-25), he discusses nine distinct meanings of the term. Buchanan
stresses that public debt can have both real and monetary effects, that it can exert
distinct effects under full employment versus unemployment, under inflation versus
price stability, amid war versus peace, when it is underwritten by banks or instead by the public, and whether public loan proceeds are spent on ordinary consumption, transfer payments, and wasteful schemes, or on capital projects (infrastructure) that yield income streams, or at least boost the productive, income-generating capacity of the private sector. Buchanan’s disaggregated approach to debt theory is more typical of classical than macroeconomic analysis, although, as we have seen, Keynes also insists that public debt proceeds be spent on investments instead of transfers or jobless relief.

“What has all of this to do with the theory of the public debt?,” Buchanan asks. He wants to explain and predict “the size of the debt itself,” as well as “the effects of issuing debt, or of changing the magnitude of the outstanding debt.” (Buchanan 1958, 20)

He also wants to eschew partial equilibrium analysis and consider the overall general equilibrium. As such, he says, critics of public debt must acknowledge that there are only three ways to finance some level of state spending – taxing, borrowing, or money-creation – and if the level of spending is assumed to be “given,” while the debt option is rejected, only taxation remains, whether it be explicit or implicit (inflation).

Borrowing is only one means through which the government secures command over monetary resources, which, except in the case of anti-inflationary debt issue, the government uses to purchase real resources. Borrowing is, therefore, an alternative to taxation. If a given public expenditure is to be financed, this can only be accomplished in three ways: taxes, loans, and currency inflation. The analysis of the effects of debt issue must, therefore, compare what will happen under the debt with what will happen under the tax or inflation. . . . Debt creation is an alternative to increased taxation, currency inflation, or expenditure reduction. When we analyze the effects of debt we must always conduct the analysis in differential terms; that is, we must allow one of the three possible
compensating variables to be changed in an offsetting way. This is the only permissible means of actually comparing what will happen with and without the debt. (Buchanan 1958, 21-22)

In short, someone must pay for government; the burden is unavoidable. To oppose debt finance, for Buchanan, is not to oppose or deny the fiscal burden per se, of some given level of state spending; it is equivalent to supporting, instead, the imposition of a compulsory tax (including inflation). Buchanan believes debt finance is opposed justifiably, on the grounds that it entails a mismatch between benefits and burdens, between current and living generations who by public debt enjoy benefits without burdens, and subsequent generations, who are made to suffer burdens without an enjoyment related benefits. At the individual (and corporate) level, one may not convey a negative-net-worth estate to the unwilling (i.e., no heir in a will must pay a decedent’s net debts); but in the public economy, government can transfer the equivalent of a negative-net-worth estate, by unlimited public debt issues. For Buchanan, this is impractical on economic grounds (as it causes capital depletion, hence successively lower living standards) and inter-generationally unjust on normative grounds.

According to Buchanan, the “bulwark” of the “new orthodoxy” (or Keynesian theory) of public debt is best captured in three fundamental propositions: 1) “The creation of public debt does not involve any transfer of the primary real burden to future generations;” 2), “the analogy between individual or private debt and public debt is fallacious in all essential respects;” and 3) “there is a sharp and important distinction
between an internal and an external public debt.’’ (Buchanan 1958, 5) Buchanan rejects each of these propositions, so he holds that public debt, indeed, shifts the real burden of government’s current costs to future generations, that there is a tight and valid analogy between private debt and public debt, and that when it comes to debt incidence, a domestically-held public debt is no less burdensome than foreign-held public debt. Buchanan also astutely notes that “these three propositions are clearly not independent of one another.” Having already surveyed the Keynesian theory of public debt, we can say that in setting out these propositions, Buchanan has not erected a straw man. Indeed, he is commendably objective in conveying the essence of the key Keynesian arguments on public debt.

As to the first proposition of the new (Keynesian) orthodoxy, that public debts are no burden shifted from current to future generations, Buchanan portrays the claim as insisting that “the process of government borrowing transfers current purchasing power from the hands of individuals or institutions to the government,” and “the utilization of this purchasing power by the government employs resources in the same general time period as that in which the borrowing operation takes place,” so “the real cost of the public expenditure” is, in fact, “borne by those individuals living in the initial or ‘current’ time period,” not by posterity. The sacrifice of real income is borne by the current generation, and this sacrifice reflects not the debt itself but government’s choice to spend on something in the first place. Whether this spending is financed by taxes or
borrowing, say the Keynesians, does not alter the fact that only the present generation is burdened; it is simply impossible to “shift” this burden to the as-yet-born, or to do so, in the future, without also forwarding the related assets, which means forwarding a positive estate. Buchanan knows how Keynesian debt theory concedes that sub-groups of society may be affected differently by tax versus debt financing, but it also argues that “debt issue leaves ‘future’ generations with a heritage of both claims and obligations,” and these “can represent no aggregate real burden because they cancel each other, at least for the internally-held public debt.” (Buchanan 1958, 6) “The public debt is, of course, not burden-less,” Buchanan argues, for “the process of making the required interest transfers involves a net burden,” and “these transfer burdens are essentially of a ‘frictional’ or ‘stresses and strains’ variety,” depending on the extent of overlap between taxpayers and public bondholders, but the “primary real burden” of a public debt is shifted to future generations. (Buchanan 1958, 7) Buchanan believes it is posterity that must pay the taxes to service the bulk of the debt, and not merely most of its interest (for longer-term bonds) but also its principal.

For Buchanan, as for Lutz, public debt is nothing more (nor less) than deferred taxation, and if the cost of government spending today, which mainly benefits the living generation, is deferred, then the living generation necessarily secures benefits without costs, while future generations must suffer to pay debt costs without corresponding benefits; the current generation effectively exploits future generations, treats them as
means, without consent. The Keynesians, of course, insist that each generation, at every point in time, gets both the assets and the liabilities; they are but two sides of the same fiscal coin; moreover, the Keynesians do not deny that the public loan is a burden, but they argue that if it is so it is presently, as a form of tax, and not a deferred tax. As we have seen, on this issue Mises concurs with the Keynesian view, not with Buchanan’s view. Central to Buchanan’s rebuttal is the observation that, unlike taxpayers, public creditors are not compelled to send funds to the state; they lend freely, and if so must get a net benefit, without sacrifice, which means the sacrifice is shifted, or deferred, to other shoulders; it is future taxpayers who must repay the heirs of initial creditors.

Buchanan’s full refutation of the first proposition – that the primary real burden of a public debt is not shifted to future generations – appears in Chapter 4 (“Concerning Future Generations”) of Public Principles of Public Debt (Buchanan 1958, 26-37). The approach, he explains, takes on a “classical form,” in that he assumes not just full employment, but that public debt is incurred for real purposes (not to influence inflation), that government secures savings that otherwise would be invested privately, and that the debt issuance does not materially alter interest rates (because public spending is small relative to GDP). For Buchanan, it is crucial to realize that “the mere shifting of resources from private to public employment does not carry with it any implication of sacrifice or payment,” for if the shift reflects “the voluntary actions of private people, it is meaningless to speak of any sacrifice having taken place,” and this is
the case whenever “an individual freely chooses to purchase a government bond,” for
“he is, presumably, moving to a preferred position on his utility surface by so doing.”
The public bond buyer “has improved, not worsened, his lot by the transaction,” and in
fact he will be “the only individual who actually gives up a current command over
economic resources,” while “other individuals in the economy are presumably
unaffected.” In short, “the economy, considered as the sum of the individual economic
units within it, undergoes no sacrifice or burden when [public] debt is created.”
(Buchanan 1958, 28-29)

Interestingly, Buchanan suggests that divergent political theories may explain
ostensible differences and confusions concerning the incidence of public debt. “It is
perhaps not surprising,” he writes, “to find this essentially organic conception of the
economy or the state incorporated in the debt theory of [19th century German
economist] Adolf Wagner,” which denies that public debts burden future generations. In
effect, all groups and generations are joined together in a collective “volk,” so none can
be specifically victimized or “burdened.” In contrast, Buchanan notes, some nations
embody “democratic governmental institutions” with a “social philosophy [that] lies in
the individualistic and utilitarian tradition,” and these will more likely discern true costs
and benefits, real perpetrators and victims. Buchanan believes fiscal scholars are
insufficiently attuned to political theory, and how it affects their analyses and policy
prescriptions. He worries that “with rare exceptions, no attention at all has been given to
the political structure and to the possibility of inconsistency between the policy implications of fiscal analysis and the political forms existent.” (Buchanan 1958, 29) One result, he notes, is that “English-language scholars” who might otherwise reject the Wagnerian ideal of the monolithic, organic state, nevertheless develop theories requiring such a state. Here one thinks, perhaps, of the British Keynes, purportedly eager to “save capitalism,” yet telling German readers, in the 1936 preface to the German edition of his *General Theory*, that his policy approach applies best in a totalitarian political setting.

For Buchanan, “an individualistic society” usually “governs itself through the use of democratic political forms,” so “the idea of the ‘group’ or the ‘whole’ as a sentient being is contrary to the fundamental principle of social organization.” In this setting “the individual or the family is, and must be, the basic philosophical entity in this society,” in which case “it is misleading to speak of group sacrifice or burden or payment or benefit unless such aggregates can be broken down into component parts” and “imputed to the individual or family.” But “this elemental and necessary step cannot be taken with respect to the primary real burden of the public debt,” for “the fact that economic resources are given up when the public expenditure is made does not, in any way, demonstrate the existence of a sacrifice or burden on individual members of the social group.” (Buchanan 1958, 29-30)

Buchanan’s rejection of the first proposition of the “new orthodoxy” is directed not only at Keynes but likewise at a famous classical economist, David Ricardo who, as
we have seen, argued for a basic equivalence, in terms of incidence, between taxes and
debt. Give the same public outlay, Ricardo calculated, society could pay for it in full, in
the present, by taxes, or instead by borrowed funds, that is, by installment, but which is
really deferred taxation; as such, math and logic dictate that the discounted present
value of that stream of future tax payments is identical to the taxes that might be paid
now, for the full outlay. Thus, for Ricardo (and to some extent for Buchanan, too), the
real burden of government is its spending, not the manner in which public spending is
paid for; but for Ricardo (unlike Buchanan) a public debt is fully discounted by the
present generation, hence no net burden on future ones. In effect, Ricardo says new
public debt causes people to lower the present value of their expected future incomes.
Of course, Ricardo ultimately advocated only tax-funding of public outlays, decrying
public debt as “one of the most terrible scourges which was ever invented to afflict a
nation.” (Ricardo 1820) Mathematical niceties aside, Ricardo seriously doubted that
people would, in fact, fully and rationally discount the future taxes associated with
public debt incurred in the present; as such, they would favor deficit-spending over
taxes, but thereby foster excessive government spending, and cause capital depletion.

Thus Buchanan disagrees with Ricardo, not because he is “Keynesian”
(mercantilist) regarding public debt theory, but because Ricardo denies that public debt
burdens are shifted to posterity; yet Buchanan agrees with Ricardo that public debt is
dangerous and inadvisable because it permits more aggressive public spending, and, by diverting private savings, impedes capital accumulation and wealth-creation.

Buchanan concludes his argument against the first proposition of the “new orthodoxy” by insisting that he has shown “that the creation of debt does involve the shifting of the burden to individuals living in time periods subsequent to that of debt issue,” that “these are the individuals who suffer the consequences of wasteful government expenditure,” but who also “reap the benefits of useful government expenditure,” and this conclusion is “diametrically opposed to the fundamental principle of the new orthodoxy which states that such a shifting or location of the primary real burden is impossible.” (Buchanan 1958, 37) His critique hinges primarily on the insight that unlike taxes, public debt is purchased voluntarily by public creditors, who presumably see a net gain in the exchange; but the cost of the government spending the debt finances must be borne by someone, somehow, at sometime; Buchanan insists it is borne by future generations, in the form of deferred taxes. This means, of course, that people in today’s living generation are paying some taxes to service the public debt incurred by their present-day parents, grandparents and great-grandparents, whose living standards would have been lower, now, had they insisted, decades ago, that their political representatives fund public spending by taxes instead of debt.

Taking the edge off his conclusion, we find Buchanan conceding that whenever states borrow to finance “useful” instead of “wasteful” outlays, posterity will “reap the
benefits” and hence suffer no net burden. It might seem that a classical liberal like Buchanan might focus less on funding modes and more on the level of government spending as a share of national income, and further, on whether the spending supplements or undermines the standard of living (i.e., whether outlays are “useful” or “wasteful”). That would be consistent with the classical approach (indeed, it is Ricardo’s main approach), except for the fact that most classical economists blithely assume that all government spending (indeed, all service sector spending – although here J.B. Say disagreed) was wasteful. Buchanan, of course, specifically rejects the “general assumption of the classical economists that all public expenditure is unproductive.”(66)

Yet a classical liberal who recognizes that unlike taxes, debt financing is voluntary, might be expected, all else equal, to favor debt funding over taxation; yet this preference is rejected by Buchanan and Ricardo alike. Buchanan’s main concern seems to be not so much to favor voluntary over compulsory financing, but to ensure that public benefits match public costs, so that no citizen or group of them can use politics to exploit others.

As to the second proposition of Keynesian debt theory – that there is no valid analogy to be found between private debt and public debt, such that a state may borrow more, or borrow under special rules or unique capacities unavailable to mere households and business – Buchanan characterizes it thus: “To the individual or the private institution, the interest charges which are necessary to service a private debt clearly represent a real burden,” and “either consumption spending or savings must be
reduced, and purchasing power transferred to the holder of the debt claim,” so “the private debt is in this way analogous to the external public debt,” “but if the public debt is internal, the holders of the claims are from the same group of individuals as the taxpayers. No net real income is transferred outside the budget of the collective entity.” The indebted individual is “placing an obligation on his expected real income over future time periods,” so “he should exercise caution and restraint in making expenditures which can only be financed by borrowing,” for too much personal debt “can place such a weight on future income that the individual may be threatened with bankruptcy.” (Buchanan 1958, 8)

When it comes to government, Keynesians claim, such conclusions do not pertain (except for externally-held debt). Since “all resources employed in making the [public] expenditure [today] must come from within the economy initially and must be used up in the initial time period,” “there can be no shifting of the primary real burden forward in time,” so “the ordinary prudence suggested for the private individual is not fully applicable as advice to the national government.” Moreover, “the size of the public debt is of relatively little concern for the public economy because the debt carries with it claims as well as obligations. To individuals who own the bonds, public debt is an asset. And since these individual bondholders live in the community along with the taxpayers, the value of the asset just matches the value of the liability represented by the debt at any chosen point in time.” (Buchanan 1958, 8)
Buchanan’s rebuttal to this second Keynesian proposition, which rejects the private-public “analogy” appears in Chapter 5 (“The Analogy: True or False”) of *Public Principles of Public Debt* (Buchanan 1958, 38-57). Again he assumes the “classical” axioms of full employment, etc. He begins by conceding that “when an internal debt is created, resources for public use are withdrawn from private uses within the economy,” such that “the creation of debt and the correspondent financing of the public project does nothing toward increasing or adding to the wealth of the society.”(39) But, he says, Keynesians draw the wrong inferences from these facts, for “when the bond purchaser buys the government bond, he draws down some other asset,” like cash, “and replaces this with the government securities,” so no change in his net worth occurs. Meanwhile the taxpayer records neither new assets nor liabilities on his own account. In aggregate, the new public debt does not alter the national net worth.

Initially then, the analogy of public debt and private debt holds. Thereafter, Buchanan insists, “the payment of interest on a public debt” constitutes “a reduction in aggregate individual net wealth,” even though “bondholders receive the interest paid as taxes by domestic taxpayers,” just as “the payment of interest on a private debt represents a drainage from the real income stream of the individual, a reduction in his net worth.”(41) Buchanan concedes that tax payments reduce the taxpayer’s assets and net worth, while the receipt of interest increases the assets and net worth of the public bondholder by a like sum, so there is no change in society’s aggregate worth (if such a
concept is valid). If so, the private-public debt analogy seems false, after all. But he insists the analogy is true, and that to believe otherwise reflects a methodological error—a failure to compare relevant alternatives. It is misleading, he says, to count the bondholder’s net worth as “uniquely increased by the receipt of interest” on his public debt, for he could have invested his capital elsewhere, and also earn interest. No special source of extra interest income emanates from public bonds. In short, “the increase in net worth of the bondholders would have occurred without the public debt,” so “only the decrease in net worth of the taxpayers” can be attributed to the new issue of public debt.(42)

Although the taxpayer sees no change in his net worth when a new public loan is floated, it is surely reduced when he pays taxes to service the new debt; without it, he would have maintained his net worth. “From this corrected analysis,” Buchanan concludes, “the public borrower (that is, the taxpayer) is at no time in a position different from the private borrower,” and as such, “the analogy between the two holds good in all of the essential respects.”(Buchanan 1958, 45) The Keynesians are wrong to insist that the state, as borrower, is different from the individual as borrower; each can borrow beyond available means; each can misuse loan proceeds by spending on “wasteful” (versus “useful,” or remunerative) projects; each can become insolvent, default, or go bankrupt. For Buchanan, the error in this second of Keynesian propositions – which claims, in effect, that sovereigns face no inherent debt limits and thus cannot truly falter or default, because “we owe it to ourselves,” while all relevant
payments cross-cancel – is to believe the interest received by the investor in public bonds uniquely offsets the taxes citizens must pay to service such bonds; in fact, had the investor lent his funds to a corporation instead of to the state, he still would have earned interest income. As mentioned, Buchanan denies that a net addition of interest income arises from new public debt, but interest expense arises, and is borne by the taxpayer.

Of perhaps greater relevance to the question of an analogy between private and public debtor, which Buchanan does not discuss in Public Principles of Public Debt, is the fact that government, by its nature and by definition, holds a legal monopoly on the use of force, while persons and companies do not. As such, only a government can legally compel tax-paying, which is crucial to its capacity for debt-paying, whereas private actors who do so commit larceny. Only a government can legally conscript labor (for military purposes) and pay it less-than-market value, whereas private actors who do so commit kidnapping. Only a government can legally issue unlimited sums of irredeemable paper money (or its electronic equivalent), whereas private actors who do so commit counterfeiting. Only a government can run the court system, including the bankruptcy courts, whereas private actors who do so obstruct justice as vigilantes.

In all these ways, by all these means, Buchanan neglects to note, a government differs from the citizen, and as such, the public debtor also differs fundamentally from the private debtor, and not merely on legal grounds, because legal sanction permits equally vast differences to arise in the financial-economic realm. Taxes can be raised to
service public debts. No government that runs its own bankruptcy courts will subject itself to bankruptcy; how then can a public creditor truly be said to ever risk “going bankrupt?” Inflation alone permits any highly-leveraged state to “live beyond its means” (i.e., deficit-spend) indefinitely; and as Keynes himself explained the relation of inflation to the real public debt, in 1923, “a government can live for a long time by printing paper money,” and “by this means secure the command over real resources” every bit as “real as those obtained by taxation,” and although “the [inflationary] method [of public finance] is condemned,” one must admit its “efficacy,” for a profligate “government can live by this means when it can live by no other.”

Buchanan also fails to note that, in an earlier, perhaps even more enlightened age, such as the 19th century, when most western governments were more constitutionally limited, were not yet aware of the wide range of potentially remunerative taxes, and were restrained monetarily by the classical gold standard, it made more sense to posit a rough congruence between powers of the individual and of the state, or between the capacities of the private and public debtor. Each faced constraints; each had to behave, fiscally, or else risk financial ruin. Today the typical government faces few such constraints, while persons and companies, arguably, face even more of them, if only because they face governments of even greater taxing, borrowing, and inflating power. Classical liberals like Buchanan might wish that this
development had never occurred, or may hope its continuation loses advocacy, but can
they deny that it seems to have negated the analogy in question?

As to the third proposition of Keynesian debt theory – that there is a
sharp and important distinction between an internal and an external public debt” –
Buchanan characterizes it thus: “The public economy, the government, has within its
accounting limits both the debtors and the creditors. The debt in such circumstances is a
mere financial transaction. No outside resources are imported and employed when debt
is created; no net reduction in income flow takes place (aside from the frictional effects
of transfer) when interest is paid or the debt is amortized.” But “if the debt is externally
held,” it is a real burden, so only “for external or foreign debt [are] the ‘classical’ or
vulgar ideas” applicable. Now in truth, Buchanan says, “the primary real burden [of
public debt] can effectively be shifted forward in time since there need be no net
domestic sacrifice of resources during the period of debt creation. The payment of
interest [also now represents] a real burden,” because the nation’s domestic income is
reduced due to interest payment sent abroad. Now it becomes valid to say “future
generations will find their incomes reduced by such transfers,” and especially when the
principal on such debt is repaid, domestic resources again must be transferred to
foreigners, and “the real burden of repayment is also borne by future generations,” so
only here “the analogy with private debt fully holds.” In the final analysis, “external
public debt may be a signal of fiscal irresponsibility, something which must be avoided
when possible,” and instead of “the rule of budget balance,” the rule should be: “taxes plus internal debt should equal public expenditures.” (Buchanan 1958, 9-10)

Buchanan’s counter-argument to this third Keynesian proposition, that an important distinction exists between the burden of a public debt that is “internal” (domestically-held) versus “external” (foreign-held) appears in Chapter 6 (“Internal and External Public Loans”) of Public Principles of Public Debt (Buchanan 1958, 58-66), and this one he deems “the most vulnerable” proposition (58), particularly as it depends on the first two propositions, which Buchanan has already rejected. On close scrutiny, he remarks, “the conceptual difference between the two debt forms disappears.” (58) The new orthodoxy, Buchanan relates, insists that “external debt would require that interest payments be made to foreigners,” which would “represent deductions from income otherwise disposable,” while “interest payments on the internal debt represent no such deductions.” (60) But this is wrong, Buchanan insists, because “the relevant comparison for meaningful debt theory is not between two situations which are identical in every other respect than debt ownership. Situations like these could never be present, and could never be constructed except as isolated and unimportant cases. Some other respects than debt ownership must be different, and any analysis which overlooks or ignores the other necessary differences must embody serious error.” (60-61) At the moment of initial choice, three options exist: finance outlays by taxes, finance outlays by debt, or choose to freeze or curtail outlays, thereby precluding altogether the need to raise funds; within
the debt option, of course, exists the further choice of whether to sell new bonds at home (internally) or abroad (externally). If outlay increases are approved, along with the debt option, a decision to fund internally will draw upon an already-fully-invested pool of domestic savings, while a decision to fund externally will draw upon an already-fully-invested pool of foreign savings.

Regardless of whether the new funding seeds a remunerative public project, “the creation of the internal public debt will act so as to reduce the community’s privately employed capital stock by the amount of the loan,” according to Buchanan, and thus future private income streams will be lower, depending on the private rate of return.(61) Resort to foreign funding, in contrast, neither reduces nor supplements domestic privately-employed capital stock, so future private income streams will be greater than had new public loan been floated internally (albeit offset by new interest payments sent abroad). Thus “the internal and the external debt cannot legitimately be compared on the assumption of an equivalent gross income stream;” “the gross income of the community in any chosen future time period cannot be thrown into the other respects which are assumed identical in the two cases and thereby neglected.”(62) Now the choice between internal and external debt finance is less obvious than the new orthodoxy assumes – and it always assumes that external public debt is burdensome to a nation, while internally-held public debt is essentially burden-less, because “we owe it
to ourselves.” Buchanan explains the relevant criteria, and why externally-sourced funding might be preferable:

The community must compare one debt form [external] which allows a higher income over future time periods but also involves an external drainage from such income stream with another form [internal] which reduces the disposable income over the future but creates no net claims against such income. The choice must hinge on some comparison between the rates at which the required capital sum originally may be borrowed. The choice between the internal and the external loan should, at this level of comparison, depend upon the relative [interest] rates at which funds may be secured from the two sources. The community should be indifferent between the two loan forms if the external borrowing rate is equivalent to the internal borrowing rate . . . [for then] the internal loan would reduce domestic private investment which would, in turn, reduce the future income in any one period by an amount indicated by the magnitude of the loan multiplied by the internal rate or net yield on capital, which is assumed to be the rate at which the government borrows. The external loan would not cause such a reduction in private investment; income in a future period would be higher than in the internal loan case by precisely the amount necessary to service the external loan. Net income after all tax payments and interest receipts are included will be equivalent in the two cases. . . . If the internal or domestic productivity of capital investment exceeds the rate at which funds may be borrowed externally, the community will be better off if it chooses the external loan form. Net income after all debt service charges are met will be higher than it would be if the alternative internal public loan were created. . . . [Only if] the internal [or domestic] rate of return on capital investment falls short of the external borrowing rate [will] the community . . . be worse off with the external than with the internal loan. Net income of the community after debt service will be lower, and the external debt will impose a “burden” [only] in a differential sense [not due, per se, to the necessary exportation of interest expense]. (Buchanan 1958, 62-63)

Having treated three “bulwark” propositions behind the seemingly idyllic Keynesian theory of a care-free and burden-less public debt, Buchanan believes his analysis “lends support to the so-called ‘vulgar’ or ‘common-sense’ ideas” on the subject
debt,” which is that public debt surely has its limits and its burdens, such that, in the immortal words of Lutz, “there is no free lunch.” (Lutz 1947, v) Buchanan believes his analysis “also re-establishes, in large part, the validity of the public debt theory which was widely, although by no means universally, accepted by scholars prior to the Keynesian “revolution in economic thought” (Buchanan 1958, 79), namely, classical debt theory, which we have already examined (in Chapter 3). The purportedly “new” public debt theory of the Keynesians, in the 1940s and 1950s “is, in fact, very old,” Buchanan explains, “for this was the commonly accepted view during the 18th century” and to the classical writers, those ideas “represented merely a part of the larger body of mercantilist doctrine,” and as mercantilist attitudes about public debt “were called ‘common’ or ‘vulgar’ by the classical writers,” so it is ironic that, as Keynesians now deride the few remaining vestiges of the classical view itself as “vulgar,” public debt theory has turned full circle.” (Buchanan 1958, 78)

Buchanan, as we have seen, suspects that political theory and practice may have come to prejudice public debt theories, perhaps so as to ensure that potentially unlimited financing is more readily available to fast-burgeoning states. Recall how Buchanan found it “not surprising” that an “essentially organic conception of the economy [and the] state” was incorporated in the debt theory of German socialists and social democrats, in the 1880s, in contrast to those debt theories that emerged from “the individualistic and utilitarian tradition” so common to “democratic governmental
institutions.” So also, in regard to the three Keynesians propositions that favor public debt, one can find great influence, on one’s conclusions, from the level of analytical aggregation. In short, who is the “we” in the phrase “we owe it to ourselves?” Is it the “we” who are taxpayers? “We” who are public bondholders? “We” in the banking sector? “We” the living of today’s current generation, or the “we” of every non-living generation, past and future? Is it “we” as Americans, or “we” as world citizens? The narrower the level of aggregation, the more disparity will exist between various entities’ benefits and costs, or assets and liabilities; the broader the aggregation, the less disparity will exist. At the global level, there is, in fact, no disparity at all, no possibility even of a positive (or negative) net worth. “We” are the world, and the world is “us.” “We” simultaneously own what we owe, and owe what we own. Logically consistent theories of public debt must avoid analytical equivocations on the level of presumed aggregation, and hence on the real meaning of “we.”

Buchanan’s criticisms of the three propositions of Keynesian public debt theory did not go unchallenged. In Ferguson (1964) various economists either supported or defended Buchanan’s critique, especially his claim that public debt unduly burdened future generations. From such exchanges arose the notion of a “public debt illusion,” wherein citizens underestimate the true cost of government if it is financed to a greater extent by debt than by taxes. The “tax price” of government products and services is lower than it should be (below cost), under debt finance, so citizens will demand more
spending than otherwise, with the result that government will grow in size, scope and
cost beyond any real necessity, and as it does, will resort to an even greater extent to
debt finance, in something akin to a vicious circle. The notion of “debt illusion” extends
the concept of “money” illusion, that people tend to be fooled by inflation (or its effects,
in rising nominal prices), feeling wealthier by it, when, in real terms, they are no better
off (or less so).

Ricardo, we have seen, denies debt illusion, as does Robert Barro (and other
“new classical” economists), so neither believe public debt burdens posterity; in effect,
everyone knows exactly what he is getting (and paying), so no one is fooled, tricked or
exploited in public finance. Keynesians (and Mises) likewise believe the real cost
(burden) of state spending is the real resources drawn from the private sector, whether
by taxes or loans, to finance the spending, and in the same period; they believe more in
money illusion than in debt illusion, but unlike new classical and public choice
economists (and Mises), welcome them as expedient palliatives, and hold that state
spending exerts a “multiplier” effect. Buchanan does not deny public debt illusion, but
denies it alters his thesis that public debts are deferred taxes that shift, to posterity, the
current cost of government (in Ferguson 1964, 150-163; Buchanan and Roback 1987);
indeed, debt illusion makes such cost-shifting possible, for if living generations felt the
full debt burden as much as they did their tax burden, they would resist shouldering it,
and would shift it. The counter-claim, of course, is that the same people, free of illusion, shift the debt burden precisely because they (might, potentially) feel it.

The principle (critics would say “false notion”) of a “public debt illusion,” regardless of its ultimate verisimilitude, serves as a crucial, transformative point in public choice research and debate. As we’ve seen, Buchanan (1958) focuses almost exclusively on the positive rather than normative aspects of public debt, and on its effects (“incidence”) instead of its causes. But the positive proves foundational for the normative; it anchors the debate to something solid rather than to mere arbitrary moral “intuitions.” And since the debate addresses government debt, it seems inarguable that it should include some theory (and measurement) of the proper (and actual) role of government in the advanced credit economy. Now the scholarly field of public debt studies embodies not only positive but also normative insights, and analyses not only of effects but also of causes, and causes not solely technical or historical, but also moral and political. In the two centuries prior to 1930, it was not necessary to say much more about the “cause” of large public debts than a single word: “war.” One might explore the question of “why war,” but it seemed unnecessary to ask “why so much public debt amid war?” There was no puzzle, no mystery. Only in the last century, amid the rise and expansion of unlimited democracy and of “cradle to grave” social insurance, are theorists obligated to incorporate, in their analyses of expansions in public debt and fiat-paper money, the powers inherent in both the warfare state and the welfare state.
Moreover, until 1930 the post-war, peacetime “norm” had been to re-establish budget balance, and if possible generate surpluses, to achieve debt reduction; not infrequently, this was actually accomplished. After 1930, however, came multiple decades of what we now know, in retrospect, to be an era of chronic deficit-spending, in wartime and peacetime alike, hence perpetual accumulations of public debt, and not merely in absolute terms but relative to national income. This transformation requires explanation, just as its possible future path requires prediction. It seems both foolish to ignore the potential causal role of moral-political precepts and practices, although they are not easy to quantify and lie not in the “comfort zone” of the technically-trained economist. But this is public choice, and political economy – specifically, the political economy of public credit – more than mere delineations of positivist effects.

If at least some kind of fiscal-monetary illusion is possible, certain obvious questions arise. Are these illusions perpetrated deliberately by political actors? If so, to what possible end? If so, should we displace traditional, idealistic notions of the “public servant” with more realist conceptions, say, of the utility-maximizing Machiavellian? What kind of morals underlie that kind of politics? What will be the causes and consequences of public credit and public debt under this new, more realistic “paradigm?” If instead there is no such phenomenon as fiscal-monetary “illusion,” what are other, and valid, causes and consequences of public credit and debt? If none are fooled, as the new classical economists insist, then the size and scope of government is
fully-desired and willingly-shouldered by informed and approving electorates; one need only trace the causal chain from voter preferences to Debt/GDP ratios. But what if a large minority disapproves? In a majority-rule setting – democracy – such a minority may be ignored, hence exploited, whether they be future (hence voice-less) generations or the minority wealthy now living, who are easily out-voted, yet pay a disproportionately large share of taxes, purchase a disproportionately large share of public debt, and hold disproportionately large shares of inflatible fiat-paper money.

Perhaps, instead, Mises is right to say that chronic deficit-spending and fast-rising public indebtedness reflect not some mysterious “illusion,” intentional or not, but only widespread popular ignorance of basic economic principles; if so, a public choice theorist might then ask whose self-interest is served by such ignorance, and by what means it is exploited, whether politically and economically.

Buchanan’s Public Principles of Public Debt (1958) triggered a healthy debate with Keynesians, as best reflected in a volume edited by Ferguson, Public Debt and Future Generations (1964). The debate in the latter volume (with many chapters drawn from journal articles) is notable because it entails both positive and normative elements; instead of debating merely the technical question of where, exactly, a public burden might rest, or how large it might be, theorists debate whether or not it is moral to shift the burden to future, consent-less generations. But only two years later, a still more ideological-moral account of deficit-spending was provided by economist Alan
Greenspan (1966), who in 1975 would become President Ford’s top economic advisor, and, in 1987 would be appointed by President Reagan to be chairman of the Federal Reserve, a position he held, by continuous re-appointment, until early 2006. Although not strictly a proponent of public choice, Greenspan shares its deep skepticism of politicians’ purported motives, and stresses what he insists are crucial links between deficit-spending, ideological devotion to the welfare state, and electoral success. In “Gold and Economic Freedom,” he writes:

Under the gold standard, a free banking system stands as the protector of an economy’s stability and balanced growth [and opposition to this system reflects] the realization that the gold standard is incompatible with chronic deficit spending (the hallmark of the welfare state), [which is] a mechanism by which governments confiscate the wealth of the productive members of a society to support a wide variety of welfare schemes. A substantial part of the confiscation is effected by taxation. But the welfare statists were quick to recognize that if they wished to retain political power, the amount of taxation had to be limited and they had to resort to programs of massive deficit spending, i.e., they had to borrow money, by issuing government bonds, to finance welfare expenditures on a large scale. Under a gold standard, the amount of credit that an economy can support is determined by the economy’s tangible assets, since every credit instrument is ultimately a claim on some tangible asset. But government bonds are not backed by tangible wealth, only by the government’s promise to pay out of future tax revenues, and cannot easily be absorbed by the financial markets. A large volume of new government bonds can be sold to the public only at progressively higher interest rates. Thus, government deficit spending under a gold standard is severely limited. The abandonment of the gold standard made it possible for the welfare statists to use the banking system as a means to an unlimited expansion of credit. They have created paper reserves in the form of government bonds which — through a complex series of steps — the banks accept in place of tangible assets and treat as if they were an actual deposit, i.e., as the equivalent of what was formerly a deposit of gold. The holder of a government bond or of a bank deposit created by paper reserves believes that he has a valid claim on a real asset. But the fact is that there are now more claims outstanding than real assets [such that the] earnings saved by the productive
members of the society lose value in terms of goods. When the economy’s books are finally balanced, one finds that this loss in value represents the goods purchased by the government for welfare or other purposes with the money proceeds of the government bonds financed by bank credit expansion. . . . Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. (Greenspan 1966)

This more politically-oriented assessment of deficit-spending persisted, and culminated, roughly a decade later, in Democracy in Deficit: The Political Legacy of Lord Keynes (1977), where Buchanan and Wagner launch what might be called a “new political economy of public debt.” More than three decade earlier Moulton (1943) had written (critically) of the Keynesian approach as “the new philosophy of public debt,” and its dominance had grown, especially among academicians and policy-makers, through the 1950s, 1960s and early 1970s. Like Moulton, Buchanan and Wagner (1977) view this “new” philosophy as the mere revival of centuries-old mercantilist (pre-classical) nostrums, deployed in contemporary times to rationalize Leviathan. They argue that Keynesian ideas and policies effectively dismantle or override what once had been an implicit fiscal constitution, as embodied in the balanced budget rule. These ideas and policies spawned an ever-expanding state, chronic deficit-spending, perpetual debt accumulation, a sabotage of the gold-exchange standard, rising inflation, and implicit debt repudiations.

According to Buchanan and Wagner (1977), Keynesian ideas effectively remove the public’s long-standing suspicion and fear of excessive deficit spending and public
debt; now these are re-packaged as safe and dependable fiscal “tools,” effective in fixing supposed free-market defects like cycles and joblessness, but also a means of stimulating a depressed economy. “With a balanced-budget rule,” Buchanan and Wagner observe, “any proposal for expenditure must be coupled with a proposal for taxation,” so “the elimination of this rule altered the institutional constraints within which democratic politics operated.” The result, they contend, is that “two subtly interrelated biases were introduced: a bias toward larger government and a bias toward inflation.”

Keynesian ideas, they say, opened a path to widespread and activist policy adoption; political elites of every stripe welcomed Keynesian doctrines, not because they were economically valid but because they were politically attractive and expedient: it rationalized their pre-existing, self-interested desire to amass and exercise power. Under the “old” (classical) fiscal philosophy, if politicians resorted to deficit spending and debt booms they were derided as irresponsible, and deserving ouster from office; but under the “new” fiscal philosophy Keynesian policies politicians were viewed as humanitarians deserving of frequent re-election. Buchanan and Wagner (1977) incorporate a perennial “vote motive” in their account of deleterious fiscal trends, but also stress that, absent ideas, policies do not follow, or do not gain sufficient popular support. Their solution is both ideational and institutional: Keynesian debt theories and policies must be refuted for the danger they pose and the harm they inflict, and to help
politician tie their own hands, fiscally, Americans should convene to adopt a balanced budget amendment to the U.S. Constitution.

The political economy “turn” in the public choice of public debt is apparent in Buchanan and Wagner (1977); less space is devoted to positive analysis or effects and more to political-institutional causes. In their chapter on “Keynesian Economics in Democratic Politics,” they write as follows:

Those who seek to understand and ultimately to influence the political economy must become political economists. Analysis that is divorced from institutional reality is, at best, interesting intellectual exercise. And policy principles based on such analysis may be applied perversely to a world that may not be at all like the one postulated by the theorists. Serious and possibly irreversible damage may be done to the institutions of the political economy by the teaching of irrelevant principles to generations of potential decision makers. Has the teaching of Keynesian economics had this effect? The question is at least worthy of consideration. We might all agree that something has gone wrong. The record of deficits, inflation, and growing government is available for observation. We must try to understand why this has happened before we can begin to seek improvement. Our central thesis is that the results we see can be traced directly to the conversion of political decision makers, and the public at large, to the Keynesian theory of economic policy. At a preliminary and common-sense level of discussion, the effects of Keynesian economics on the democratic politics of budgetary choice seem simple and straightforward . . . Elected politicians enjoy spending public monies on projects that yield some demonstrable benefits to their constituents. They do not enjoy imposing taxes on these same constituents. The pre-Keynesian norm of budget balance served to constrain spending proclivities so as to keep governmental outlays roughly within the revenue limits generated by taxes. The Keynesian destruction of this norm, without an adequate replacement, effectively removed the constraint. Predictably, politicians responded by increasing spending more than tax revenues, by creating budget deficits as a normal course of events. (Buchanan and Wagner 1977, 95)
The fiscal context observed by Buchanan and Wagner in 1977 is instructive, and on the surface does not seem to corroborate the theme of *Democracy in Deficit*. In 1977 Keynes’s *General Theory* (1936) was forty years old, its principles filled the economics textbooks, and most policy-makers self-identified as Keynesian. During these four decades the U.S. government ran budget deficits 75% of the time and borrowed 10% of its total spending, yet by 1977 the U.S. federal debt was only 35% of GDP, down from 40% in 1936 and relative to an all-time peak of 121% in 1946. In contrast, the four decades prior to 1936 saw the U.S. running budget deficits 50% of the time and borrowing 27% of total outlays, while the ratio of U.S. federal debt to GDP jumped from 8% (1896) to 40% (1936). On the whole, it appears that the four decades after the Keynesian “revolution” of 1936 entailed *less* deficit spending (10% of outlays) and a *diminishing* public debt burden (the debt ratio declined from 40% to 35%), while the four decades before 1936 entailed *more* deficit spending (27% of all outlays) and an *increasing* debt burden (the debt ratio quintupled, from 8% to 40%). Perhaps Keynes was not so influential after all (at least by this brief empirical comparison); instead of causing theoretical trends, perhaps he only reflected them.

Yet there is a monetary aspect to the context of 1977 that corroborates Buchanan and Wagner’s theme – an important aspect which flows directly from Keynesian policy prescriptions and explains the seemingly benign trend in the U.S. Debt/GDP ratio. Keynes was a long-time critic of the gold standard, and despite occasional expedient
exceptions, strongly advised states to abandon or attenuate it; whether he did so to mitigate deflation, to permit more deficit-spending, or both, is not as relevant as the fact that when the international gold standard was, indeed, finally abandoned (by three major steps, in 1914, 1933 and 1971), it provided much wider scope for deficit-spending: a state-controlled means (fiat-paper-money issuance) of reducing the real burden of the public debt, by a deliberate and surreptitious inflation, which, as Keynes himself noted, in 1920, “not one man in a million is able to diagnose.” The last vestiges of a gold-based U.S. dollar were ended by President Nixon in 1971, just six years before *Democracy in Deficit* appeared, yet Buchanan and Wagner were alert to the fiscal implications of the new paper dollar, in a section titled “Budget Deficits Financed by Money Creation.”

Among all the ways sovereigns might extract resources, inflation is perhaps the most indirect, and that which requires the highest degree of understanding on the part of the individual. Even to analyze inflation as a form of taxation seems open to question when our ultimate purpose is that of understanding human behavior. Governments do not present inflation as a form of tax, as a balancing item in published budget projections or reviews. Governments instead make efforts to attribute the causes of inflation to nongovernmental entities and events—to profit-hungry capitalist firms or greedy trade unions, to foreign oil cartels, poor harvests, and the like. If the effects of money issue, in terms of behavioral reactions, should be, in fact, equivalent to those of a tax, there would seem to be no point in all such activities of politicians. Something a bit
closer to reality is approximated by the popular references to inflation as a “hidden tax.”
But the reality is simpler. Elected politicians approve programs of public spending; they impose taxes. If they are not required to balance projected spending with revenues, they will not, because the voting public does not hold them directly responsible for the inflation that their actions necessarily produce. (Buchanan and Wagner 1977, 114)

In a nationalistic (versus internationalist) monetary system of fiat-paper money (versus gold-based money), states can create purchasing media *ex nihilo*, and virtually without limit; that is, they can debase the value of money. Although this policy becomes visible mainly in the form of price inflation, states can easily attribute rising prices to an economy’s more visible price-setters in the business world, deflecting attention from the less-transparent money-creators residing in the political world. Most crucially, unanticipated inflation erodes the value of public debt (indeed, of all debts), which benefits debtors at the expense of creditors (bondholders). In the forty years between the appearance of Keynes’s *General Theory* (1936) and Buchanan and Wagner’s *Democracy in Deficit* (1977), the U.S. Consumer Price Index increased by 345%, nearly triple the increase registered over the previous forty years (+116%, 1896-1936). Nominal GDP in the U.S. grew 24-fold from 1936 to 1977, but only 5-fold from 1896 to 1936. In absolute terms, nominal U.S. public debt increased 21-fold from 1936 ($34 billion) to 1977 ($706 billion), but could still decline relative to nominal GDP because inflation was so rapid. The real value of U.S. debt increased only 5-fold from 1936 to 1977. Likewise, from 1977
to 2012 U.S. nominal public debt has increased 23-fold, but by only 8-fold in real terms. As Buchanan (1959) explained previously, regarding the “real” debt, so Buchanan and Wagner (1977) recognize inflation’s power not to “eliminate” the cost or burden of public debt, but to dissipate and scatter it. By inflating states default on their debt implicitly (indirectly), not explicitly (directly, by non-payment), which makes the debt appear less costly than it “really” is. Inflation effectively disperses the default costs among bond-holders and money-holders alike. Of course, one might say a public debt “really” and truly is less of a burden, when reduced, in real terms, by inflation.

Buchanan also examines the normative aspects of public debt and inflation, which he views as causal, much as he does economic ideas and political institutions. In “The Moral Dimension of Debt Financing” (1985) he chastises economists for having “almost totally neglected moral and ethical elements of the behavior that has generated the observed modern regime of continuing and accelerating government budget deficits,” and “to the extent moral principles affect choice constraints,” this “neglect is inexcusable.” Buchanan further contends that “the explosive increases in debt or deficit financing of public consumption outlays can be explained, at least in part, by an erosion of previously existing moral constraints,” those which he elsewhere labels “the Victorian precepts” (prudence, parsimony, budget balancing), and which Keynes, as “a moral revolutionary,” sought to dismiss or destroy, by resort to “allegedly rational arguments for fiscal-monetary debauchery.” Buchanan also indicts the human motive that is said to

391
most drive economic behavior — “rational self-interest” — for when this motive has driven “political decision-makers,” it “has always dictated resort to non-tax sources of public revenues.” Whereas balanced budgets were “formerly dictated by [Victorian] moral standards,” those are by now long gone, so budget balance should be decreed legally, as by a constitutional amendment. By the late 1980s a growing scholarly interest in the normative aspects of public debt inspired studies of attitudes about the morals of public debt in the history of thought. (Borna and Mantripragada 1989).

We have seen how Buchanan fears that a combination of Keynesian fiscal fallacies and unlimited majority rule can foster chronic deficit-spending, perpetual public debt accumulation, inter-generational cost-shifting, and a morally-dubious resort to surreptitious methods of inflationary finance (implicit default). Yet interestingly, he also argues that an ethical case can be made, by an over-leveraged government, for deliberately and explicitly defaulting on its debts.

In “The Ethics of Debt Default” (1987) Buchanan begins by explaining that “there is widespread recognition that this pattern [of reckless] fiscal behavior cannot be sustained permanently,” because there are fixed and objective limits to how much public debt can be incurred and serviced. He meticulously defines certain of these limits, including one he calls a “critical threshold.” But as to his point about the ethics, versus the metrics, of public leverage and default, Buchanan contends that precisely because there is “widespread recognition” of the risks of public debt, it can be ethical for a state
to default. “Widespread recognition” will include, of course, recognition by the investors who own risky public debt, or contemplate doing so. Indeed, such bondholders are usually financially sophisticated; eyes wide open, they know the risks and rewards of bond-holding, and purchase or hold their bonds voluntarily. Indeed, astute public bondholders can discern, better than most, a sovereign’s true financial condition, and thus the likelihood and magnitude of default, whether to be explicit (by non-payment of interest or principal) or implicit (by inflation). If the likelihood of default is great, investors will only pay a price that is far below the bond’s face value, which means they will earn a far higher yield-to-maturity, compared to yields on safer bonds. In short, investors in risky, high-yielding public (“junk”) bonds are fully and fairly compensated for the risks they assume, and often for many years. In this way, public bondholders are not necessarily harmed by states which default.

At some point, a state’s fiscal distresses will become so acute that interest expense on its debt crowds out and prevents other budgetary spending, to the harm of a large portion of citizens. “At this juncture,” Buchanan explains, “it is apparently to the short-run self-interest of citizens, as taxpayers-beneficiaries, to default on existing public debt, either directly through explicit repudiation or indirectly through inflation.” A “default on existing obligations will allow current rates of [public] spending on goods, services and transfers to increase and/or current rates of taxation to decrease.” (Buchanan 1987, 361-362) Note how he says citizens may have only a “short-run self-
interest” in defaulting – given their immediate dependence on ordinary budgetary outlays that are being crowded out by interest expense – not a long-run self-interest. That is because the debt-defaulting state might lose access to affordable credit for years to come, so its funds will have to come, in which case it might have to impose more taxes and inflation on citizens.

Needless to say, Buchanan’s unique (and seemingly irrefutable) case for an ethical default on unduly burdensome and risky public debts has been met with analytic eyebrow-raising, even among public choice allies, such as Brennan and Eusepi (2002, “The Dubious Ethics of Debt Default”). “In the entire Buchanan output,” they write, “there is perhaps no more astounding paper” than “The Ethics of Debt Default,” for a deliberate debt default seems an unethical act which “many contractarians might seem unthinkable,” although, to be fair, they add, Buchanan’s paper is only “an investigation of ethical issues surrounding debt default,” and is “not a ringing endorsement” of it. Still, “that a lifelong exponent of contractarian ethics and a well-established authority on the economics of public debt should suggest [that a public debt default may be ethical] certainly makes one sit up and take notice.” After closely examining Buchanan’s argument, they reject it unequivocally: “There is abroad a strong intuition, apparently powered by general contractarian sentiments, that defaulting on public debt is ethically outrageous in principle and could only be contemplated in extreme circumstances. Strong intuitions ought to require strong arguments to unseat. As far as we can see,
Buchanan provides no such arguments. He certainly appears much more hospitable to
the possibility of debt default than one might have expected him to be, but his grounds
for such hospitality strike us as thin.” (Brennan and Eusepi 2002, 559) In fact, widespread
acceptance of inflation – which is but one form of default – alone refutes the Brennan-
Eusepi claim that today the standard “intuition” opposes defaulting on public debts as
an act which is “ethically outrageous.” In fact, default has many advocates, not only in
explicit form (after hatred has been whipped up against lenders) but especially in its
inflationary (implicit) form, and further, in the form of artificially-low interest rates.

Interestingly, part of the counter-case in Brennan-Eusepi (2002) rests on a
rejection of Buchanan’s view that public debts burden future generations and allow
current ones to benefit from state largess (via deficit-spending), virtually scot-free. In
their own words, “[public] debt financing does not necessarily leave future generations
as a whole worse off than tax financing, even when the revenue is used for current
consumption,” and “even if debt financing does lead to smaller net bequests than would
prevail under tax financing, this is not necessarily a bad thing.” (Brennan and Eusepi
2002, 559) They conclude that unilateral default is unethical, but it is morally justifiable
for an over-extended sovereign to offer public bondholders a “debt renegotiation.” Yet
could such a “negotiation” be fair, when the sides are by no means legal equals?

Buchanan’s argument for an ethics of sovereign debt default, based on the
rational expectations of sophisticated investors (public bondholders) who, by receiving
high yields, are adequately compensated for default risk, is not, in fact, a novel one. This was Britain’s foreign debt policy since at least 1848, as conveyed in a diplomatic circular, the “Palmerston Doctrine,” and as recounted by Sir John Simon, of the British Foreign Office, in a 1934 speech: “My predecessor Lord Palmerston, who is not generally regarded as having been backward in the defense of British interests, laid down the doctrine that if investors choose to buy the bonds of a foreign country carrying a high rate of interest in preference to British Government Bonds carrying a low rate of interest, they cannot claim that the British government is bound to intervene in the event of default.” (cited in Eichengreen and Lindert 1989, 19).

Close scrutiny of Buchanan’s scholarship reveals that he discovered more than an old set of ideas and accomplished more than a mere rehabilitation of classical public debt theory. He broke new ground and developed new insights in the field of public debt, due largely to a novel and universal extension of the classical “economic man” premise to political actors. These actors are not saints, are not exempt from basic human motives, he argued; they too pursue their self-interest, and thus, if only for realism’s sake, it is incumbent upon scholars to study and expose what this political self-interest entails and what are its main effects. Buchanan developed new aspects of both positive and normative public debt theory, but perhaps his most enduring contribution will be his exploration and explication of the institutions of public finance generally and of public debt specifically – i.e., the norms, rules, laws, and constitutional provisions that
shape the dimensions and determine the trends of public debt, as well as the reasons such institutions are altered, or why, instead, they seem to be mysteriously unalterable and inexorable. These are the questions posed under what he calls “the institutional-choice approach to fiscal systems.” (Buchanan 1967a, 256) There is, in the Buchanan view of the world – whether the focus be positive, normative, or institutional – a healthy appreciation for the happy median, or what Aristotle called “the golden mean.” Neither democracy nor autocracy can do the job, nor win our lasting moral allegiance. Neither is consistent with liberty, prosperity, or fiscal integrity.

For Buchanan, what works best practically and is superior ethically is the constitutionally-limited government, a system located “between anarchy and Leviathan.” (Buchanan 1975) Empirically, it is has long been known that autocracies have difficulty securing access to public credit; they are not trusted, and even if they are, they rule over unproductive lands, and even if they do gain access to public credit, before long they tend to abuse it. More recently, unrestrained democratic regimes (see Greece) – have also abused public credit (and creditors). This is no surprise to Buchanan, who contends that “even under the most favorable conditions the operation of democratic process may generate budgetary excesses,” such that, “democracy may become its own Leviathan unless constitutional limits are imposed and enforced.” (Buchanan 1975, 161)

Of course, the thesis that unlimited democracy is prone to causing a war of the majority poor against the minority rich, and to degenerating into tyranny, is as old as Aristotle.
The most recent research on the political economy of public credit and debt come from Brennan (2012) and Wagner (2012). In his journal article, Brennan reasserts the public choice insight that "public debt (as opposed to current taxation) alters the inter-temporal pattern of tax rates," by reducing current tax rates and increasing future ones, but this is only background context for a more novel hypothesis: that demographic trends may explain chronic deficit-spending and perpetual debt accumulation. For every nation one may calculate an "age profile of income," and Brennan posits that this might determine the citizen’s relative preference for tax-funded and debt-funded public spending. He assumes, consistent with "most standard models of political economy," that "individuals vote according to their economic interests," that a public debt is mainly a deferred tax, and that tax burdens tend to be greater not in one’s youth but in one’s later, higher-earning years. Brennan then suggests that the younger is a populace, the better off it will perceive itself to be with tax-funded public spending, while the older it is, the better off it will perceive itself to be with debt-funded spending. The younger prefer taxes because they are not yet in their high-earning, high-tax years; they prefer no debt funding, because they will likely live long enough to have to service it in far-distant years. In contrast, the old folk will prefer debt, for that lightens their current (high) tax load, and they will not be around in far-future years to service the debt.

Broadly, Brennan predicts that "the pattern of support for public debt will track age," such that "increases in the median age of [a] population will lead to a larger public
debt.” If so, then “public debt policy collapses [into] a kind of demographic politics.”

Unfortunately, empirical tests of the novel proposition have, so far, yielded mixed results. Japan has an aging population and a fast-growing Debt/GDP ratio, which fits Brennan’s hypothesis, but this one case skews the results of a study of twelve OECD nations in the post-war period; the regression is not robust. Yet this is the kind of originality and intelligence that typifies the public choice approach to public debt.

Wagner’s performance in Deficits, Debt and Democracy (2012) adds further value to the growing corpus of public choice insights on the political economy of public credit and debt. Here the unique contribution is to apply to public debt the principle of the “tragedy of the commons,” whereby land owned by no one in particular, but open for use by all, is over-harvested and ultimately dissipated. The solution is clearly-defined private property rights, sanctity of contract, voluntary trade, and other institutional guideposts and restraints that can prevent tragic and mutually-harmful behavior. Wagner contends that this is precisely how future generations are being treated under modern systems of public finance, typically Keynesian, that generate chronic deficit-spending and indefinite debt build-ups. Eventually the future generations come to live in the present, and must suffer to bear the extra (tax) burdens made possible by the profligate public borrowing of ancestors. There is, according to Wagner, “a tragedy on the fiscal commons.” Real people are being exploited – treated as fiscal chattel, non-consensually; real capital is being dissipated; living standards are at risk. The problem is
not public debt *per se*, but a political system – virtually unlimited democracy – lacking in the necessary legal-constitutional limits.

The main defect in Wagner’s account is its failure to acknowledge how most public borrowing is at an average duration less than two decades, or well within the definition of a generation today; as such, public debt today cannot be classified as exploiting “future generations.” There may be exploitation of some groups by others, but all parties seem very much alive; it is not perhaps some mysterious or amorphous “futurity” or “posterity,” but rather real, live human beings who are being sacrificed.

5.6 Public Choice and Public Debt: From the Past to the Future

Despite the many achievements of public choice scholars in the realm of public debt theory, much is still unclear or unknown, which means much remains to be done. According to Munger (2004), despite public choice warnings over the years, “the tendency to use [public] debt rather than taxes to finance current government activities is predictable and preventable,” yet also “politically irrepressible.” Politicians (and most economists) believe that “[budget] deficits and large accumulations of debt are benign,” while voters prefer the impossible policy troika of high government spending, low taxes, and no public debt. The first two preferences usually outweigh the third, so public debt keeps climbing:

We have [a] problem with our understanding of deficits. . . . What are the actual impacts of deficits, economically and politically? What will be the impact of the end of the brief period of surpluses in the U.S. federal budget? And, if the surplus is now dead, was it murdered, or did it commit suicide, falling victim to
irresistible forces in the U.S. political system? . . . [W]e don’t know very much about deficits, in the direct “X causes Y” way necessary for policy analysts to advise leaders effectively. While it may be true that deficits might “eventually” have important real macroeconomic effects, their short and intermediate term effects are hard to predict. There is something we do know, however, and the failure to communicate it effectively to the public, and to policy makers, represents an important failure of academic economists. The tendency to use debt rather than taxes to finance current government activities is predictable and preventable, but it seems politically irrepressible. . . . Deficits are not something like earthquakes or floods, the natural consequence of random or deterministic process. Instead, deficits are the aggregate consequence of the self-interested individual actions of hundreds of elected and appointed officials. In fact, this observation, based on individual self-interest and aggregation, are the sine qua non of the public choice approach. . . . [T]he extreme form of Ricardian Equivalence, combined with the Keynesian policy prescription for deficit spending as a positive good, constitute an important “idea.” What this idea has enabled, however, is the empowerment of a set of interests whose political goals have little to do with the abstract utopian economysticism of the Keynesian macro-control scholars. . . . To most politicians, of any of the main partisan affiliations, it now seems established that deficits and large accumulations of debt are benign, or at worst only pose a danger far off in a distant future. The problem is that these political “leaders” may be sending a message that the electorate would take issue with, if it were presented as a package rather than piecemeal. The problem is not just that voters are too passive and disorganized to respond. The real problem is that [what] voters want is perfectly sensible, but impossible to deliver because it is not feasible. Voters want three things: (a) lower taxes, (b) increased spending on “needed” programs, and (c) lower deficits. (Munger 2004, 236, 242, 244, 246)

We have seen that public choice theorists aim their polemical weapons primarily at Keynesian public debt theory, especially the claim that deficit spending entails no real economic burden and can cure unemployment. But public choice also rejects arguments on public debt advanced by new classical economists such as Barro (1974, 1989), that while public debt neither supplements national wealth nor stimulates the economy,
neither is it harmful to prosperity. Public choice theorists, in contrast, hold that budget
deficits should be incurred only during war and other real emergencies (economic
depressions), or in the case of an infrastructure build-out (to the extent it can be shown
to redound to the benefit of future generations).

Deficit spending and public debt issuance, from the public choice perspective,
are merely different forms of taxation – viz., deferred taxation. The political argument is
that unlimited democracy embodies political elites’ electoral need for majority support,
so politicians are incentivized simultaneously to maximize spending (which current
voters prefer) and minimize taxation (which current voters also favor). The unavoidable
result is deficit-spending, which requires public debt issuance. But again, such issuance
is deferred taxation, the taxation of future generations, which obviously do not consent
and cannot influence present-day politics. In this sense public choice may be said to
provide an explanation for the rise and spread of supply-side policy prescriptions in the
1980s; instead of opposing deficits and demanding tax hikes to close them – a losing
electoral combination – the idea was to advocate tax cuts, create deficits, and hope
others might so fear their effects that they would support spending restraint.

Unlike Keynesian theorists, who argue that deficits and debts benefit the
economy, and Barro, who contends that they are innocuous on that score, public choice
theorists believe they are harmful, unless incurred for war or remunerative
infrastructure investment. Public choice makes an important contribution to the public
debt debate with its analyses of debt incidence and “debt illusion.” The first concept, debt incidence, pertains to the ultimate burden of the public debt; since public choice holds that public debt is but a deferred tax, its ultimate burden is said to fall upon future generations. But this same argument implies that current generations are now being burdened by the public debts previously incurred by generations that are now today’s parents, grandparents and great-grandparents. The second concept, debt illusion, posits that current generations do not feel the full burden (cost) of current spending on public goods, due to relatively low taxes; given the artificially low price of public goods, more of them are demanded than is efficient. This same excessive demand for public goods leads, in turn, to further deficit-spending, which in turn generates still more public debt. If true, the fiscal state is unstable and unsustainable.

If public choice theorists are correct that public debt is largely a burden on future generations, not current ones, they contribute to an explanation of the vast rise in the scope and cost of government over the past century, and make a case that either an out-voted minority class of the rich or un-represented future generations are exploited – used as a “fiscal commons.” The critique relies on the well-known inefficiencies and dangers of common property; there is “over-grazing” in the absence of carefully-defined and legally-protected private property. Yet proponents of the argument have a difficult time convincing current generations to curb or cease their exploitation, especially if it
requires receiving fewer government benefits or paying higher taxes; the costs seem too distant, and the would-be victims of the future are perfect (imagined) strangers.

Public choice theorists rightly stress both the positive and normative aspects of public debt; since such debt arises precisely in the context where the demand for public goods exceeds the ability or willingness to pay for such goods (by taxes), they address norms pertaining to fairness, free-riding, rent-seeking, and exploitation. It is possible that positive insights aside, political elites knowingly endorse an expansive, even over-leveraged state, without admitting so publically, on the ground that normative values should trump positive ones. Public choice theorists and some political economists also stress the need for “credible commitments” in fiscal-monetary policy, and warn, rightly, of the “time inconsistency” problem entailed in policy pronouncements and actions over time. Governments during the past century, while becoming more democratic, have not also become notorious for consistently being just, honest, or pacific. The concept of “credible” is linked closely to “credit.” Unless a government can commit credibly to maintaining its credit (its ability and willingness to service its debt), it will be discredited publically, and will find it more difficult to issue more debt, or to do so affordably. The most believable, credible commitment offered by political elites today is that they will keep waging undeclared and thus often interminable wars, and will preserve, protect and expand their welfare systems, at any cost; this requires more public debt, not less.
If private actors and political elites alike are driven by self-interest, as public choice theorists contend, it seems that the dilemma of the “fiscal commons” can never be fully or even partially resolved, at least not without some deeper change in society’s predominant, underlying ideology, in its prevailing conceptions of fairness, or justice, and in its expectations about government’s proper role in the economy. Public choice scholars are perhaps right to focus on the inter-temporal (and other) asymmetries that threaten national fiscal ruin, and to suggest constitutional-institutional cures (a balanced budget amendment, a gold standard, electoral term limits). Yet when they offer reforms which might pre-restrain political actors by more stringent fiscal-monetary institutions and constitutions, as a way to resolve public spending and debt problems, critics are right to question why the same general public that prefers the policies which generate excessive spending and public debt would not also oppose the institutional reforms that might permanently curtail or nullify popular preferences. If a democratic electorate truly opposed large public deficits and debts, it would vote accordingly, and no constitutional-institutional fiscal-monetary restraints would be necessary; if instead the same electorate condoned large public deficits and debts, no constitutional-institutional restraints would be effective. Ideology, ultimately, may determine political institutions, for good or ill; if so, inter-disciplinary public choice scholars might be best-equipped to drive the debate.
6. The Limits of Public Credit

Having surveyed and assessed the theories of public credit and debt advanced over the past three centuries by Classical, Keynesian, and Public Choice scholars, our focus turns now to the narrower question of the “limits,” if any, of public credit and public debt. We have discovered, in the long history of public debt theory, distinct strains of pessimism, optimism and realism about public debt, regarding its origins, effects, morality, and sustainability. We have also learned, by carefully weighing the merits and demerits of various arguments, that the perspective and interpretation proffered by realists are more logically persuasive and also more closely corroborate the empirical record. Of course, each perspective – pessimistic, optimistic, and realistic – has its contemporary proponents, but here, as we survey and investigate the limits of public credit and debt, we adopt and apply the more illuminating and credible realist position.

By the “limits” of public credit we mean the ways in which public credit and debt might begin to break down or no longer operate efficiently, in the expected manner, as well as theories of the cause of credit breaches or debt overhangs, and metrics for gauging or predicting them. This sub-category of the theory of public credit and public debt also examines the ways governments pre-empt or respond to excessive deficits and debts, whether by fiscal austerity, restructurings, repudiations, explicit defaults, or implicit defaults, why they adopt these various devices, and the implications of each. On a deeper level, the political economy of public credit and its limits considers regime
types – i.e., whether the causes and consequences of public credit and its limits differ in autocracies, democracies, and constitutionally-limited republics, or in advanced-developed nations, in contrast to developing nations.

Those portions of the academic literature which analyze the public debt “burden,” or the more recent notion of “debt intolerance” (Reinhart, Rogoff, and Savastano 2003), relate most closely to the investigation at hand, namely the ultimate limits of public credit and debt; yet our interest now is not merely in the ways public debt imposes a burden, on whom it is imposed, or when, or how such burdens might be shifted inter-temporally, inter-generationally, or internationally. These questions are not unrelated to that of the limits of public debt, but now we wish to investigate hypotheses and tests regarding debt burdens that, for whatever reason, have become so great as to entail breakdown or crisis.

Other parts of the public finance literature also deal importantly with the issue of debt “limits,” but by indirection – as in the already-substantial sub-literature on “optimization.” Thus we observe theory and empirics on the optimal size of the public sector, the optimal tax rate, the optimal inflation rate, the optimal mix of taxes and inflation, and, perhaps most relevant for our immediate purposes, the optimal mix of taxes and public debt, the optimal mix of internal and external public debt, and the optimal size of public deficits or debts (whether measured in absolute terms or relative to national income). In such projects scholars first identify the criterion or “objective
function” which they propose to optimize, whether it be individual utility, social welfare, real per-capita GDP, GDP growth, or some GINI coefficient of income equality, while also considering budget constraints, time horizons, and whether or not to incorporate the expected utilities of future generations. In taxation we know how the traditional Laffer Curve proposes an income tax rate that is neither too high nor too low but just right, at least for purposes of maximizing overall government revenues; likewise, calculations have been made for a “debt Laffer curve” (Stijn 1990, Husain 1997, Agénor and Aizenman 2005).

Whatever the value of such studies, it is perhaps too facile, even useless, to declare that an as-yet-undefined sum of public debt is “unsustainable.” This is the most-used but least-meaningful term in discussions of public debt. It is true but trite to say the unsustainable cannot be sustained, for it is so by definition. That which cannot be sustained will not be sustained; but what is worth learning is how, when, and why the presently-sustained state of affairs might become a different state of affairs.

6.1 Dysfunctional Finance?

In the 1940s, as we have seen, Abba Lerner, the Keynesian, advanced certain positive principles of public debt, which he characterized as “functional finance.” A study of breakdowns in public credit and public debt might be called “dysfunctional finance.” Unlike John Maynard Keynes, or even Alvin Hansen, the “American Keynes,” Lerner made overt and unabashed claims in support of unrestrained deficit-spending,
public debt issuance, and inflationary finance; in his own words, “functional finance rejects completely the traditional doctrines of ‘sound finance’ and the principle of trying to balance the budget;” moreover, Lerner believed the “instinctive revulsion” that people have “to the idea of printing money,” and to “the tendency to identify it with inflation, can be overcome.” (Lerner 1943, 41).

For Lerner, “the size of the national debt is relatively unimportant,” and interest on it “is not a burden on the nation,” so “the nation cannot be made ‘bankrupt’ by internally held debt.” By his account, “the weird notion of a country ‘going bankrupt’ because it has a great internal debt can only be explained as a result of private capitalists building up a conception of the State in their own image and impressing this capitalist mythology on the other members of the capitalist society.” (Lerner 1944, 304) Yet Lerner later concedes, amid intensifying criticism of his views, that in some cases (mainly when too much public debt is owed to foreigners), “too large a [public] debt can be a serious matter.” (Lerner 1948)

The problem is that Lerner, like most public debt theorists, provides no discernable metric to determine or predict when, precisely, a normal debt condition might transform into what he calls “a serious matter,” that is, when a public debt shifts from being safe to being dangerous in level or proportion, how it might do so, why, and what a sovereign can or should do about. To be fair, Lerner rejects the very notion of a “problem” here, in need of solving. The main purpose of his entire system of “functional
finance” is to view matters not from some *a priori* presumption that there exists some fixed or objective standard, or rule, of fiscal rectitude, never to be abrogated; rather, he says, the focus should be on the functioning of the economy and how the state may help it function better. In public policy, Lerner effectively tells policymakers to do “whatever it takes” to keep the economy functioning, regardless of past traditions, customs, orthodoxies, or rules. If it seems necessary to solve some alleged problem of high public debt, the state can simply resort to money-printing, to pay its way, and if that brings inflation, the state should simply tax cash balances or impose price controls.

### 6.2 Public Credit as Public Debt Capacity

In any study of “limits” in public finance there is value and clarity in maintaining, in the course of one’s analysis, the crucial distinction between *public credit* and *public debt*, a distinction which appears all too infrequently in the relevant literature. We have seen how, in the 1940s, Lutz (1947) was an exception in this regard. Typically the literature focuses on the public debt, which is more tangible and quantifiable than public credit, especially as it comes in the form of tradable securities held by investors for income and gains (or losses) in real-life investment portfolios. Less tangible and measurable is public credit, although this is, in many respects, the more crucial concept, and the main reason we title this work not the political economy of public debt but rather “the political economy of public credit” – because this pertains to the *capacity* of a state to borrow, not to its actual outstanding obligations (public debt).
The “public credit” might more easily be conceived as equivalent to a “line of credit” on a personal credit card, or for a company, at its bank; the banker, \textit{ex ante}, makes periodic assessments of the overall “credit capacity” of the borrower (or would-be borrower), based on such well-established criteria as character, income, existing debts, credit history, and collateral; the lender must also decide what interest rate to charge, and which rate best matches the risk of lending. In such cases, it is, obviously, risky for a private borrower to borrow so much that he uses up his entire borrowing capacity. Thus there seems a clear and distinct limit to private debt, indeed, a line of private credit, and stiff penalties for breaching it. Here, as in the economy broadly, there is value in preserving unused credit capacity, or some safe margin between one’s credit and debts, to assure flexibility, liquidity and solvency.

Public lenders must make similar decisions, but by the nature of the borrower they face – the sovereign state – there is usually less precision in estimates of public credit. The outstanding debts are well-known and easily measured, of course, but how close they are to the state’s ultimate borrowing capacity is less obvious. Typically sovereign debt is measured in proportion to national income (GDP), yet national incomes of similar size may not exhibit similar taxable capacities, and hence will not be similar in yielding the revenues necessary for debt service. Ambiguous “off-balance sheet” public obligations, usually associated with under-funded entitlement programs, further complicate the analysis. Yet sovereigns surely have credit limits of some kind,
however much they may vary, for history is replete with cases of sovereign debt
defaults. (Reinhart and Rogoff 2009, Reinhart and Rogoff 2010). In such cases public
credit is breached; public debt has come to reach or exceed the public credit, and the gap
between credit and debt can narrow and disappear either by public credit shrinking,
public debt rising, of a combination of both. Obviously, the two concepts of credit and
debt are not synonymous. But how public credit is measured and how public lending
occurs within its non-stationary boundaries seems more an art than a science.

There is some value in holding up, as a rough guide at least, the traditional
analogy between the private debtor and public debtor; in fact, we deployed the analogy
above, in an attempt to better distinguish credit and debt. But the traditional analogy
cannot and must not be strictly construed, given the radically different nature and role
of government over the past century, compared to the previous one; by now the
sovereign debtor wields a virtually unlimited power and capacity to tax, to create
money, to avoid its own bankruptcy courts, and if necessary, to unilaterally re-cast its
own debts in ways not welcomed by its reluctant and unwilling lenders.

As mentioned, further complicating the private-public “analogy” is the fact that,
beyond explicit debts (bonds), governments over the past century (unlike those in the
prior century) also issue rhetorical and often ambiguous (although many insist, still
“real”) obligations, through “entitlement” programs (social insurance, whether for
pensions, medical care, or bank deposits), and typically these are “unfunded.” If, as the
term “entitlements” implies, citizens are truly “entitled” to receive such promised public benefits, it seems a government is also “obligated” to pay them. It is, then, a type of debt, and must be considered, in combination with explicit public debt (bonds), in the context of an overall umbrella of (bigger and broader) public credit. How do these obligations relate to a sovereign’s credit capacity, and especially to its unused capacity? Precision of measurement is difficult when one tries to relate a tenuous, ambiguous, unfunded obligation to an equally amorphous “public credit.”

Entitlement obligations are, perhaps, more easily altered than are the relatively-fixed features of publicly-traded sovereign bonds, yet they remain real obligations, in some crucial sense, and as such, must be made to fit under the broad cape of “the public credit.” Indeed, “entitlements,” contrary to the usual interpretation, may be less susceptible to revision or reduction by an over-leveraged sovereign than are its explicit and tangible bonds, especially when political actors face an aging, dependent population which is also active electorally, and when even modest attempts to reduce entitlements, to the detriment of this expanding constituency, constitutes a “third rail” in politics, instantly killing the careers of would-be reformers. In an unlimited democracy, it seems obvious that the sovereign would more likely break its pledges to bondholders on Wall Street (or China) than to seniors on Main Street. That contemporary sovereigns speak of backing their unfunded, off-balance sheet obligations with their own “full faith and
credit” is testament to the fact that such a thing as “public credit” exists; it is this “limit” that too few public debt theorists examine or measure, as they examine public debts.

6.3 Metrics for Public Debt Crises and Defaults

Theorizing about the limits of public credit, or debt capacity, and quantifying the precise location of debt “tipping points” is more art than a science. Early efforts at specifying a limit to public debt were made by Wright (1940), while Hansen (1941, 136) showed empirically that Britain had borrowed more than 200% of national income in 1818, and more than 150% in 1923. At present, Japan has the highest Debt/GDP ratio among advanced nations (220%), even though, as we will see, the latest empirical studies suggest a 90% debt ratio as the upper limit beyond which advanced nations begin to experience difficulties, and a still-lower ratio (60%) for less-developed nations (Reinhart and Rogoff 2009). In 1940 Wright reacted against increasingly extreme claims that there were no effective limits on how much a sovereign might borrow – claims typically associated with Lerner:

In “An Economic Program for American Democracy” [1938] it is argued that the national debt may be increased indefinitely – apparently, in fact, without limit. In this article I propose to examine some of the bases for such a contention. . . . Are there any definite limits to the rise of the public debt? Few questions evoke more controversy and more confusion. The layman is likely to consider merely what he would do, if he were confronted by an ever-increasing number of bills which had to be paid . . . Such a mode of thought is clearly inadequate, but it is equally unwarranted to go to the opposite extreme and deny that an internally held debt can ever be a burden. Truth, it is submitted, lies somewhere in between, but we must realize from the start that we cannot speak of “limits” in the sense of a sudden line beyond which one cannot possibly go. We must speak rather of increasing frictions. At what point these frictions will become unbearable
depends on the political attitude and enthusiasm of the people. The economist cannot prophesy a breaking point, he can only indicate tendencies toward one. . . . The most nearly definite limit on the amount of government spending is the desire to avoid a price inflation. . . . Clearly, credit creation within a period must not exceed the flow of purchasable goods in that period; if the flow of credit creation is greater, price inflation will result. But aside from this limit on stimulation there are certain other limits of an institutional nature which are said to confine the growth of the national debt. I need not mention the statutory debt limit of the country, for that can obviously be changed. The two problems which concern us most here are, first, whether the size of the national debt is limited by the size of bank reserves, and second, whether the expansion is limited by a saturation of the market for government bonds. (Wright 1940, 116-118)

Wright’s discussion is interesting because it contains so many of the different strands of public debt theory we have come to study in this work: he cannot pinpoint a limit for public debt, but surmises that one surely exists; he suspects the private-public analogy is inadequate; he knows excessive debt financing can become inflationary, and that banks are part of that process; he also acknowledges that the “political attitudes” of the people will play a role; and he is aware that there are institutions and rules associated with public debt that will prove pertinent to limitations. Wright contends that it is possible the public might refuse to buy more public bonds, although, he adds, banks could be coerced into doing so. The real limit of public debt, he says, is not the interest expense (which is income to others) but the higher taxes and inflation that may accompany it, and may be resented by business and households. Moreover, “it is theoretically possible for deficit financing actually to cause a decrease in investment and consumption” (Wright 1940, 123), in something of a reverse multiplier effect. But Wright
says no more about limits. He offers minimal rigor on the question, and no empirics. His main aim is to strike a balance between fiscal conservatives who oppose large spending and project dire consequences from high public debt, and the extreme Keynesians, like Lerner, who insist there is no effective ceiling on the height of public debt, and that if government can borrow no more, it should print money.

One of the more interesting attempts in contemporary times to specify a precise upper limit for public credit and public debt appears in an article by Buchanan (1987), where the main goal is not a positive but rather a normative analysis of public debt default. Buchanan seeks to relate and synthesize such seemingly disparate factors as the amount of public debt, its growth rate, the economic growth rate, the ratio of public debt to national income, the prevailing interest rate on public debt, and total interest expense on the public debt as a share not only of government spending but of the annual budget deficit, if any:

So long as the rate of increase in interest-bearing public debt exceeds the rate of economic growth, the interest charges on the public debt as a share of total product must increase. Either total public outlay must increase as share of total product or interest charges as a share of total budgetary totals must increase. At some point, the annual interest charge will come to equal and then exceed the annual deficit. Once this critical threshold is passed, the simple economics of default come into play. If government is unable to borrow funds that are sufficient to meet annual interest charges on accumulated debt, default on existing obligations will allow current rates of spending on goods, services and transfers to increase and/or current rates of taxation to decrease. At this juncture, it is apparently to the short-run self-interest of citizens, as taxpayers-beneficiaries, to default on existing public debt, either directly through explicit repudiation or indirectly through inflation.” (Buchanan 1987, 361-362)
One might call this the “algebra” of public debt and its limits, at least in verbal form, although the actual algebra and formal inter-relationships have been presented in greater detail subsequent to Buchanan (see Blejer and Cheasty 1991, Frisch 1997). Buchanan notes that if public debt grows faster than the economy, it is unavoidable that the Debt/GDP ratio must rise, and if as this occurs there is no decline in the prevailing interest rate on the public debt, then interest expense also must rise as a share of GDP. Since interest expense on the public debt is part of the annual government budget, either total spending must grow in proportion to GDP, or if it does not and spending growth is restrained (say, in other budget categories), then interest expense on public debt will grow relative to total spending. Of course, a rising public debt by definition means deficit-spending. For Buchanan, the “critical threshold” is the equality between annual interest expense on the public debt and the annual budget deficit. At this point the sovereign is borrowing anew just to pay interest on its past borrowing; this is not merely borrowing to roll over or repay old principal that is due. There is now a chance the debt burden will spiral out of control. It is worse still if annual interest expense comes to exceed the annual deficit (i.e., new borrowing), for then “the simple economics of default come into play,” as “the government is unable to borrow funds that are sufficient to meet annual interest charges on accumulated debt.”

Providing context to Buchanan’s concept of the “critical threshold,” it is worth noting that interest expense on U.S. federal debt during the most recent fiscal year
(ending September 30, 2012) was $450 billion (at an average interest rate of 2.73%), compared to an annual budget deficit of $1.1 trillion. The U.S. national debt is now $16.1 trillion. To exceed Buchanan’s “critical threshold,” the “annual interest charge” must “come to equal and then exceed the annual deficit.” But we observe that in fiscal 2012, interest expense on U.S. public debt ($450 billion) is less than half the deficit ($1.1 trillion). It seems the U.S. is safe for now, even by Buchanan’s algebra; yet it seems odd that a larger budget deficit should make us more sanguine about current public debt levels, simply because its size so easily dwarfs annual interest expense. If the U.S. deficit were suddenly a mere tenth of its current size, less much less than current annual interest expense, why would that necessarily spell trouble? By Buchanan’s calculus, it would.

Perhaps by his debt algebra Buchanan seeks to capture the dilemma of a “debt spiral,” as occurs at the intersection of a large debt and the inexorable law of compound interest. If one must borrow anew merely to pay interest on prior borrowings, one pays interest upon interest, and in time, one cannot dig out of the ever-deepening hole. Initially fiscal deterioration is slow and default risk is low; before long, each is swift and severe. A Hemingway character was asked, “How did you go bankrupt?” The answer was apt, given the typical sequence: “Two ways. Gradually, then suddenly.”

Happily, the contemporary literature offers an abundance of alternative theory – and more recently, historical studies, too – on limits and crises in public credit and debt.

Below we examine each of these research programs, in turn: on the causes of public debt, optimal public debt levels, the causes of debt defaults, and the aftermath of high public debts and defaults.
According to Barro’s rather simple but subsequently influential model (1979), public debt is incurred primarily as a means of smoothing tax policy over the course of the business cycle, to avoid frequent and distortive alterations in tax rates. Instead of meeting cyclical deficits (due to recessions) with tax increases or spending cuts (either of which might further depress the economy), and to avoid meeting cyclical budget surpluses (due to economic expansions) with tax cuts and spending increases (either of which might unduly stimulate the economy), governments instead allow deficits to run and thus borrow in downturns, but then, in upturns, allow for surpluses, as an ultimate source of debt redemption. Permanent, longer-term public debt accumulates only in emergencies (like war); otherwise no chronic deficit spending or debt build-ups need occur due to the business cycle. Tax smoothing has the further benefit of preventing a pro-cyclical policy (i.e., raising taxes in recessions to close deficits, cutting taxes in recoveries to prevent surpluses). “A central proposition,” Barro writes, “is that [budget] deficits are varied in order to maintain expected constancy in tax rates,” and “debt issue would be invariant with the outstanding debt-income ratio” and also “with the level of government spending.”

In a more developed, sophisticated model, Brennan and Buchanan 1980 (103-105) assume a “Leviathan” government intent on maximizing not the public good but its net revenues, either permanently (what they call “perpetual Leviathan”) or only occasionally (what they call “probabilistic Leviathan”). Public borrowing is but deferred
taxation, and because it “provides a means for Leviathan to allocate desired revenue use
inter-temporally, its major importance stems from the fact that [it] offers an additional
revenue source in its own right.” Brennan and Buchanan assume that Leviathan’s debts
“must be honored,” else no one would lend to it. In this model, “the total amount that a
government can borrow is or may be constrained in three ways: (1) by the ability of the
government to service and redeem the debt – that is, the future revenue capacity
assigned to government defined by its constitutionally allowable taxing powers; (2) by
the relative preferences of individuals as between government bonds and other assets;
and (3) by the general extent to which individuals wish to postpone current
consumption (and acquire assets).” (Brennan and Buchanan 1980, 103-105)

Brennan and Buchanan further note that “the power to create bonds is futile
unless government also has the power to tax,” and “the power to borrow in itself assigns
to government no power that is not already embodied in the assigned revenue
instruments to which it has access.” In essence, “the power to borrow permits
government [to] appropriate now, in some current period, rather than later, the
capitalized value of the future revenue streams.” Whereas borrowing by a perpetual
Leviathan (autocracy) shifts the timing but not the level of public outlays, the case is
“dramatically different under probabilistic Leviathan,” because now “the power to
borrow implies that the revenue-maximizing government, finding itself in office and not
anticipating to remain, may, by means of borrowing, appropriate to itself the full value
of tax revenues in all future periods, including those in which such a Leviathan is no
longer operative.” In short, “the power to borrow effectively transforms the
‘probabilistic Leviathan’ into ‘perpetual Leviathan’ from the standpoint of the
taxpayer.”(104) For Brennan and Buchanan, “limits to governmental power to borrow”
“may also be set by ‘supply’ characteristics of asset markets,” and since the sovereign’s
bonds can face competition from alternative investments, “[it] may find it necessary to
pay higher and higher rates,” with the result that “future government revenue may be
exhausted before all private assets are replaced by [public] bonds.”(105)

Finally, they argue, “limits are set on the ability of government to sell bonds by
the maximum level of the community’s capital formation” and savings, for “government
cannot acquire more from” the representative saver than his level of savings in the
current period – but only ‘as long as we continue to assume bond purchases are
voluntary.”(106) If individuals do not do as Ricardo assumes they will – that is, they do
not discount into the present the future tax bills that may arise amid a higher future debt
– they will make more of their savings available to the state today, so it can borrow more
than it otherwise might. Access to foreign savers can also dramatically expand
Leviathan’s borrowing capacity: “if Leviathan can sell debt externally,” Brennan and
Buchanan explain, “there is no way that the [domestic citizen] can make offsetting
behavioral adjustments even if he fully anticipates the future-period tax liabilities. And
if no such anticipation occurs, the maximal saving does not limit debt issue as in the
internal debt case. How much can Leviathan borrow in such circumstances? The limits are those imposed by the full capitalized value of future-period tax revenues,” in addition to current tax revenues.

For Brennan and Buchanan, “this finding suggests that the total ‘burden of debt’ will potentially be much larger under external than under internal debt, simply because more debt will be issued in the former case.” In the absence of “constitutional constraints on the ability to borrow externally” that are “particularly severe,” Leviathan’s debts will become both excessive and dangerous (to bondholders).

Acknowledging their roots, Brennan and Buchanan believe their analysis “tends to reinforce classical precepts that limit government resort to this revenue-raising instrument to periods of demonstrable fiscal emergency,” and “if the citizen-taxpayer, at the constitutional stage of decision, projects only the possibility that a revenue-maximizing Leviathan may emerge,” then “rational choice should dictate a preference for quite severe constraints on the governmental power either to levy taxes on capital or to create public debt.” (108) They also explain how a government “power to create money” permits yet a third source of revenue for Leviathan, how “money is rather like a form of debt,” how the sovereign “needs to pay no interest on its implicit loan,” and how “the value to [Leviathan] of a perpetual interest-free debt is equal to the principal – the real value of the money stock itself.” (111-112) In short, Leviathan’s power to issue near-limitless sums of paper money, especially in the absence of a gold standard, helps it
dissipate, by stealth, a material portion of the real value of its debt. (Brennan and Buchanan 1981)

Cukierman and Meltzer (1989) attempt an integration of economic and political theory to argue that public debt is determined by popular demands for wealth redistribution, not only among classes now living, but between current generations and those yet to come. Privately, of course, one may not legally impose net debts on anyone, heirs included, whereas those who leave positive-net-worth estates are seen as altruistic. Cukierman and Meltzer surmise that public debt arises because most citizens do not wish to pay full freight for the government they get, so they try do publicly what is not permitted privately: inter-generationally selfish, they try to pass on negatively-valued estates. In the authors’ words, “the existence of a positive national debt is directly traceable to the existence of a sufficient number of individuals who desire to leave negative bequests but are prohibited [under law] from doing so. By voting for [government][ deficits, they increase their consumption, crowding out capital.” The more people are “bequest constrained” (i.e., less-wealthy, so less likely to bequeath positive estates), the more they will vote, in matters of public finance, for debt-based versus tax-based spending. “[P]eople who benefit from debt finance” include not only those with relatively lower wages today, but “those with low wages, relative to the wages expected by the next generation,” so they “will try to tax future wealth,”
meaning: they will try vote to have the state borrow now and then tax subsequent
generations. (730-731)

For those wondering about those seemingly odd episodes when “fiscal
conservatives,” not free-spending Keynesians, generate massive deficit-spending and
offer a pertinent model. Investigating “why a stubborn conservative would run a
[budget] deficit,” these authors contend that “a conservative government,” although
superficially “in favor of a low level of public consumption,” nonetheless suspects it will
be “replaced by a government in favor of a larger level of public consumption,” so by
borrowing now instead of taxing, it can burden its less-conservative successors with
debts to be serviced by future tax hikes or spending cuts (see U.S. experience in the
1990s, following the more conservative 1980s).

In a series of papers published in the 1990s, Harvard’s Alberto Alesina, joined by
various co-authors, presents both positive and normative theories of deficit-spending
and public debts (Alesina and Tabellini 1990, Alesina and Tabellini 1992, Alesina and
and Tabellini (1990) contend that “budget deficits and debt accumulation” serve two
basic purposes: first, “they provide a means of redistributing income over time and
across generations,” and second, they “serve as a means of minimizing the deadweight
losses of taxation” associated with government spending. (Alesina and Tabellini 1990,
Taxes tend to distort economic activity, and public borrowing can minimize these distortions. The authors believe their model can better explain the seeming aberration of persistent deficit-spending in peacetime, as well as the large variation in debt policies pursued by nations with economies that otherwise seem similarly situated.

Clearly influenced by the public choice approach, Alesina and Tabellini “abandon the assumption that fiscal policy is set by a benevolent social planner who maximizes the welfare of a representative consumer,” and posit, in its place, two self-interested political rivals with distinct objectives who are compelled, electorally, to alternate their office-holding. Yet the authors reject “the political economy of budget deficits” as promulgated by “James Buchanan and his associates,” because, they claim, it is “based upon the somewhat questionable notions of ‘fiscal illusion’ and voters’ irrationality.”

Clearly, Alesina and Tabellini seek to reconcile public choice premises (regarding self-interested political elites) and new classical insights (about rational expectations), in the hope of improving upon the theory public debt. Echoing Persson and Svensson (1989), they try to demonstrate how, in the face of inherent political “disagreement between current and future” policymakers, “public debt is used strategically by each government to influence the choices of its successors.” The predictable result, according to Alesina and Tabellini (1990), is a political system with “a bias towards budget deficits,” such that “the equilibrium stock of public debt tends to be larger than [is]
socially optimal." Society, although presumed to be devoid of “fiscal illusion” and “irrationality,” nonetheless are ill-served by political leaders. Alesina and Tabellini blame not democracy *per se* but a lack of genuine democratic consensus: “It is citizens’ disagreement, rather than their myopia, that may generate a deficit bias in democracies.”

In their model, “the equilibrium level of public debt tends to be larger: (i) the larger is the degree of polarization between alternating governments; (ii) the more likely it is that the current government will not be reappointed; (iii) the more rigid downward is public consumption.” Thus if political elites find it difficult to cut public spending, or even to restrain its rate of growth, and in addition, political divisions are stark while electoral turnover is high, deficit-spending and public debts also will tend to be high.

In another effort, Alesina and Tabellini (1992) provide a literature review that focuses on political theory – namely, whether the sovereign is best construed as a benevolent dictator with the public good in mind, or instead as a self-interested revenue-maximizer. They also wish to ask which types of political regime are likely (or not) to generate high public debts. “A general result” in the literature, they find, is that a “fragmentation of [political] power and lack of unified control leads to myopic [fiscal] policies, such as borrowing or delaying a tax reform.” “[P]olitical incentive constraints create a bias towards both high debt and high inflation.” But whereas in one line of argument these problems are said to be caused by “political instability” (by a “frequent turnover of governments with different preferences”), another line of argument,
drawing on cases of “decentralized government,” insist that “a myopic [fiscal] policy does not reflect a deliberate choice, but rather the inability to take a collective decision,” due to “a fragmentation of power among different decision makers.” It is relevant also that nations can differ in their political institutions. Some scholars find that “high public debt countries are almost exclusively parliamentary democracies with a highly proportional electoral system,” and conversely, “almost all countries with such a political constitution have very high public debt.” Two factors that most coincide with high public debt are “unstable governments” that are “formed by a coalition of parties” and a material resort to debt monetization and inflationary finance (“seigniorage”). “Myopic” public finance policies include not only inefficient taxation, but large fiscal deficits and an undue reliance on external debt financing.

In a closely-related study, Alesina and Perotti (1995) investigate why it is that several (though not all) OECD nations accumulated so much debt between 1970 and 1990. Debt/GDP ratios in relatively high-income democracies (Belgium, Ireland, Italy, Greece, Spain) doubled during this time, to 100%. Unable to identify credible economic causes of such large increase in public leverage, the authors posit the influence of “political-institutional factors” – electoral laws, party structure, budget laws, central bank laws, and measures of political centralization, stability, and polarization. As with other scholars, Alesina and Perotti try to explain persistent deficit-spending even in peacetime, but also, in that context, why some nations deficit-spend more than others.
At bottom the authors attribute large, persistent deficits to “strategic conflicts between political parties or social groups.” (16)

As elsewhere, such findings imply a troubling conclusion, at least for classical liberals: it suggests balanced budgets can be achieved only amid perfect political consensus and one-party rule. Consistent with public choice insights, Alesina and Perotti (1995) believe institutional structure is needed to induce leaders to curb fiscal profligacy; yet they worry that balanced budget laws will rob policymakers of the flexibility needed to adopt counter-cyclical measures. They want autonomous central banks, yet know they are tempted to monetize public debts. (see also Thornton 1984)

In a textbook chapter summarizing the extant literature a dozen years ago, political economists Persson and Tabellini (2000) set the context by asking why “[public] debt accumulation varies greatly over time,” and stress from the outset that the “tax-smoothing” model of Barro (1979) can explain, at best, only the kind of extraordinary but transitory deficits and debt build-ups seen in war-time, not the chronic deficit-spending in peacetime so common after 1960. “Debt and deficits,” they submit, “appear to be correlated with specific political and institutional features: debts have been accumulated by countries ruled by coalition governments and/or unstable governments. Budgetary procedures that confer veto rights or disperse political power among several decision makers are also correlated with debt accumulation.”
These facts suggest that political and institutional factors play an important role in shaping public debt policy,” as do “powerful political interest groups.” (Persson and Tabellini 2000, 345) At the time, the authors no doubt were impressed by the fact that the non-parliamentary U.S. was in the middle of a four-year run of budget surpluses (1998-2001), which itself had followed a five-year run of steadily-dwindling deficits (1992-1997); by 2000 the U.S. public debt ratio had declined to 57%, from 68% in 1996, while public debt ratios were rising steadily and dangerously in nations dominated by unstable, coalition governments. Yet in the decade after 2000, amid near-full Republican control of all branches of the federal government, the U.S. debt ratio increased from 57% to 85%. Here, of course, the Persson and Svensson (1989) model makes more sense, for it purports to explain “why a stubborn conservative would run a [budget] deficit.” He would do so, recall, in order to tie the fiscal hands of his expected political successors, who are likely to reside in the opposition (liberal) party.

Persson and Tabellini (2000) erect “a simple two-period economic model that embeds special-interest politics,” and “a common pool problem,” where collectively the incentive is to take, not give, and thus to raid the treasury. Deficits are not unavoidable. “As the property rights to current and future tax revenues are not well-defined, all actors have an incentive to spend a lot and to spend soon, in order to appropriate more resources.” The living treat future generations as fiscal commons. Where revenue-raising is centralized, but “spending decisions are decentralized,” they explain, a combination
that is typical in parliamentary systems characterized by proportional representation and coalition governance, “there is a tendency not only [for sovereigns] to overspend, but also to over-borrow.”(345) The influence of the public choice school is obvious.

Velasco (2000) likewise “develops a political-economic model of fiscal policy” and public debt in which “government resources are a ‘common property’ out of which interest groups can finance expenditures on their preferred items,” a case which yields “striking macroeconomic implications,” including that government “transfers [of income and wealth] are higher than a benevolent planner would choose them to be; fiscal deficits emerge even when there are no reasons for inter-temporal [tax] smoothing; and in the long run government debt tends to be excessively high,” as “high net transfers early on” eventually give rise to “high taxes later on.” In short, certain rent-seeking groups are enabled and empowered to game the political system and live off the productive efforts of other groups. Although these “implications” are “striking” to Velasco, they would elicit little surprise from scholars like Mises, Lutz, and Buchanan, who are critical of democracy’s tendency to become unlimited in domain, who deny that governments are staffed by anything that even resembles a “benevolent planner,” and who observe that failure in socialized systems (of common property) is probable, because private property rights are undefined (or illegal), and as a result, resources are treated as a common pool, prone to over-use, and abuse, to the point not only of yielding a diminishing utility or return, but diminishing wealth.
A “positive political economy of public debt” is offered by Franzese (2001), with an empirical focus on post-war experience in twenty-one advanced (OECD) democracies. He notes how “theoretical literature seeking to explain public-debt accumulation exploded in recent years as debt crises emerged in many nations” (in the early 1990s, mainly in Europe, but notably in Nordic nations). Like prior scholars, Franzese laments that the tax-smoothing thesis of Barro (1979) remains dominant, even though it seems to explain merely infrequent, dramatic episodes of deficit-spending (amid war), not the chronic build-ups of public debt that became the norm by 2001.

Drawing on the post-1979 theoretical literature, Franzese for the first time empirically tests “nine positive-political-economy-of-public-debt theories” which seek to explain perpetual deficit-spending and debt accumulation by factors such as “government fractionalization,” political-ideological “polarization” (partisanship), wealth and age distributions (affecting inter-generational transfers), electoral and political budget cycles, “strategic debt manipulation” (to restrain opposite-party successors), “distributive politics and multiple constituencies,” tax code complexity, fiscal illusion, and a lack of central bank autonomy from the state. Franzese finds strong evidence for six factors: the tax-smoothing thesis, fractionalization, polarization, electoral budget cycles, tax code complexity, and fiscal illusion. Other factors exert only a mixed or weak influence. Franzese’s tests compel him to reject the oft-cited hypothesis (at least among public choice scholars) that wealth and age distributions spawn large
public debts (as a way to defer taxation and burden future generations), and to reject also the notion that political officeholders strategically manipulate debt to tie the hands of would-be political opponents who might succeed them.

In a summary statement, Franzese argues that the “impetus” for “high and/or swiftly rising public-debt-to-GDP ratios” among “developed democracies in recent years” “originates in the different distributions of political and economic influence in capitalist democracy, which fostered transfer-payments growth, which drove spending-growth more generally, which, finally, governments typically partially debt-financed.” (1) By his account, in the 1990s “economic conditions worsened as stagflation in the 1970s continued into the 1980s, driving democratic governments, given their commitments to social-insurance, public goods, and macroeconomic-management provision, into debt. Then, as these governments shifted to monetary contraction to control inflation, real interest rates rose,” thereby “exacerbating the problems by increasing interest rates on newly accumulating debt.” (66) The problem was most acute in those democracies that failed to reduce their debt in post-war peace decades. Franzese believes “the evidence demands eclecticism in explaining developed democracies’ postwar debt experiences,” for although “the data support most of the arguments proposed in the literature, and all of the variables suggested can have substantively important impacts on debt under the right (or wrong) conditions” (66), nevertheless his
“all-encompassing model” explains “only about half (53%, un-weighted) of the total variation in developed democracies’ debt experiences from 1956 to 1990.” (67)

Distinct from theories and studies of the political-economic causes of public debt accumulation are theories and studies of the optimal levels of public debt, a field that naturally precedes a study of actual public debt defaults, their causes, and their consequences. Sachs (1989) is the first to suggest an optimal level of public debt, such that even too little of it is an inferior policy, but Claessens (1990) elaborates the concept, and dubs it the “Debt Laffer Curve,” after supply-side economist Arthur Laffer, who in the 1970s had specified how, by imposing an optimal tax rate a government might indirectly maximize its tax revenues, by motivating the private sector to maximize its income and gains. Sachs had used the concept of a debt optimum to argue for international debt relief for less-developed countries (LDCs); he argued that their onerous debt service burdens were not unlike an onerous tax, and were this burden reduced, the over-extended public debtor would be in a better position to repay a discounted sum of debt, just as its public creditors would benefit more than if they were to insist upon payment in full.

Claessens (1990) offers precise estimates of optimal debt levels, and explains how a nation might be on the wrong or right side of “the debt curve,” just as it might be on the wrong side of the Laffer tax curve (in the “prohibitive range”). Similar to the concept of the optimal public debt level, or the optimal debt ratio, is the concept of the public
debt “overhang,” whereby debt is deemed too large, and thus debt service too onerous, to allow the degree of economic growth needed to repay the debt per se. Key to optimization calculations is the gap between the nominal (face) value of public bonds and their market value; the latter is, of course, much lower if there is a high probability of a future default. The effective yield-to-maturity is much higher than the fixed coupon rate; this is a sovereign “junk” bond. The Debt Laffer curve, which moves out of the origin toward the northeast in two-dimensional space, is a joint plot of the nominal bond value (horizontal axis) and the market value (vertical axis). At lower levels of public debt (here measured in proportion to a nation’s total exports), bondholders expect full payment, so nominal and market values are close; in contrast, at higher debt levels, a future debt default is more likely, such that the market value of public bonds declines relative to their nominal value (and the latter increases due solely to the additional debt issuance); the peak height of the curve signifies an optimal debt level. Claessens shows how, for over-indebted LDCs, a partial but not unilateral debt forgiveness is optimal.

Joines (1991), a supply-side colleague of Laffer, asks how large a budget deficit the U.S. can shoulder. “Governments may be unable to sustain large budget deficits indefinitely,” he notes, because the investor has in mind a limit as to how much he will hold, based on the Debt/GDP ratio. Joines “explores the sustainability – rather than the economic consequences – of government budget deficits,” but of course the two are not unrelated; if budget deficits hurt (or help) an economy, they necessarily also hurt (or
help) its taxable capacity, hence the government’s capacity to service its own debt. As is
typical of debt scholars, Joines relates nominal debt to nominal GDP, and insists debt
service is secure as long as nominal GDP growth keeps pace with or exceeds debt
growth. Of course, nominal GDP is a joint product of real growth and inflation, so the
implication is that inflation can (and should) mitigate public debt burdens. Joines cites
“historically typical levels” of Debt/GDP ratios in the U.S., although an average masks a
large range; still, he reckons the U.S. can safely run deficits of $175 billion p.a. “in the
near term,” and “even larger” deficits in “future years,” without raising taxes. “One
need not reduce the deficit to zero,” he says, “to hold the public debt stable at its current
ratio” to GDP.

After walking through some of the algebra of public debt, Joines stresses that
“the real value of the government debt cannot grow forever at a rate greater than the
real interest rate.” For public debt to be sustainable “the government must run current
and future non-interest [budget] surpluses equal in present value to the principal and
accrued interest on its outstanding debt.” Moreover, if the real interest rate “exceeds the
growth rate of real national income,” then the Debt/GDP ratio will increase without
bound, and if so, “the government has a greater incentive to default, either explicitly or
by eroding the debt’s real value through inflation.” (Joines 1991, 3-4)

This principle – of the ameliorative power of inflation to at least partially relieve
debtors of their debt burdens – is stressed strongly again, nearly two decades later, in a
paper by Irons and Bivens (2010) which aims to rebut forecasts (by Reinhart and Rogoff 2009) of gloomy consequences of high public debt levels in the aftermath of the great recession of 2007-2009. Of course, inflation also lowers the real interest rate, making it less likely to surpass real GDP growth – a key gauge of sustainability, at least for Joines. How high can the Debt/GDP ratio safely go? “Economists have no idea” of its “upper limits,” Joines writes, “nor do they have evidence that relatively high levels of debt are inconsistent with rapid economic growth” (4-5), and yet, he also asserts, “the size of the debt/income ratio is still important.”(7) Why? Because a high debt ratio “forces a government to levy higher tax rates for any given level of spending,” which imposes “welfare costs on society, since it distorts economic decisions.” Worse, “at sufficiently high debt/income ratios [Joines does not say how high], the government cannot collect enough tax revenue to service its debt. Thus the assumption that investors impose an upper limit on the size of government debt is reasonable.”(7)

If Joines is right that public debt theorists and analysts should listen closely to the market messages being sent by public bond investors, recent market news is good for the U.S. In 1991 the U.S. debt ratio was 60%, or half its peak level in 1946, and although real U.S. GDP increased 4.5 times since 1946, because of inflation, U.S. nominal GDP increased far more so during that time, namely 27-fold. The U.S. debt had risen 13.4 times from 1946 to 1991, or triple the rise in real GDP, yet the U.S. Debt/GDP ratio was halved, from 121% in 1946 to 60% in 1991. Joines does not cite this specific data, and
does not advise inflation, but his analysis shows how inflation lessens debt burdens.

The annual U.S. deficit from 1992 to 2012 exceeded his threshold of $175 billion per annum nearly two-thirds of the time, while averaging $542 billion per annum, and the U.S. debt ratio jumped from 63% in 1992 to 105% in 2012. Yet the average yield on the 10-year U.S. Treasury bond was only 1.85% by 2012, versus 7.00% in 1992. With yield as an objective market indicator (as suggested by J.S. Mill in 1838 and Antonio De Viti De Marco in 1936), one might say U.S. public bonds are more secure in 2012, even amid wider deficits and much higher leverage, than in 1991, amid narrower deficits and lower leverage.

Smyth and Hsing (1995) take Joines (1991) a bit further along the theoretical path and explore “whether an optimal [public] debt ratio exists that will maximize [real] economic growth.” They develop a hypothesis that real GDP growth is determined by five key variables; the public debt ratio, the public debt ratio squared, and growth rates, respectively, in employment, capital services, and the money supply. Using U.S. data from 1960 to 1991, they find all tested variables as relevant for real growth, and reckon an optimal debt ratio of 38% for debt held by the public and 49% for total public debt. Higher debt ratios than these, they insist, will undermine a nation’s potential future growth rate. Aiyagari and McGrattan (1998), writing on the eve of a four-year run of budget surpluses in the U.S. (1998-2001, totaling $560 billion, or 10% of initial debt), argue that “concerns regarding the high level of [public] debt in the U.S. economy” are “misplaced.” The U.S. debt ratio was 64% in 1998, double the level of 1980.
For Aiyagari and McGrattan, “the welfare gains” attainable under an “optimum quantity of [public] debt” are simply too “small” to alter fiscal policy. Their model is formal, not empirical, and they find importance in the fact that government securities help enhance household liquidity. The downside of public debt, they say, is that it crowds out private capital and, by requiring higher taxes, distorts employment and savings. In their model “the optimum quantity of debt will be high if debt is effective in smoothing out consumption over the lifetime of an individual,” “low if debt crowds out capital and, therefore, lowers consumption,” and low also “if the incentive effects of higher distortionary taxes are important.” The point at which liquidity-smoothing benefits are offset by the above-named costs they designate as “the optimum quantity of [public] debt,” which they estimate to be “about equal to the average Debt/GDP ratio for the U.S. over the post-WWII period,”(461) or 54%. But again, that average masks a fairly wide range – from a low debt ratio of 32% in 1974, to a high of 121% in 1946.

Although difficult to imagine in 2012, as economists and policymakers worry about the potential problems and dangers associated with rising and potentially excessive public debts, in 2000 they were worried about the potential problems and dangers associated with declining and potentially deficient public debts, as reflected in an unpublished inter-agency document of U.S. government titled “Life After Debt.” (U.S. Government 2000, Kestenbaum 2011). When the U.S. ran budget surpluses four years in a row, from 1998 to 2001 (inclusive), for the first time in a half-century (1949-1952),
public and private economists projected that the U.S. national debt might be reduced to zero by 2012. A debate ensued: would zero public debt be helpful or not for policymaking and the economy, and should budget surpluses be devoted to something besides debt redemptions, such as replenishing unfunded entitlement programs? The Federal Reserve worried that monetary policy might become less effective, because much of it was conducted through the buying and selling Treasury securities in open-market operations. (Reinhart and Sack 2000, Fleming 2000, Greenspan 2001) Obviously, this debate became moot when the recession of 2001 and terrorist attacks of 9/11 returned the U.S. to perpetual deficit-spending; instead of U.S. public debt declining from $5.7 trillion (57% of GDP) in 2000 to zero in 2012, as some were forecasting at the time, it nearly tripled, to $16.1 trillion (105% of GDP). In 2000, as a Federal Reserve economist, Vincent Reinhart worried about a case that now seems impossible – “the economic consequences of a disappearing government debt” (Reinhart and Sack 2000). Today he worries about the consequences of a public debt “overhang.” (Reinhart, Reinhart, and Rogoff 2012). The root assumption, of course, is that there is an optimal level of public debt.

Having examined contemporary theories of public debt and why such debt even arises, then theories of “optimal” debt levels (or debt ratios to GDP), followed by theories of why public debt becomes excessive, next we examine theories that seek to explain the basic causes of public debt defaults, as well as more recent empirical studies
of the aftermath of high public debt levels and defaults. Our account provides valuable context for our final judgment of the political economy of public credit and debt.

In the midst of Latin America’s sovereign debt crises in the early 1980s (including Mexico’s default in 1982) appeared a paper by Eaton and Gersovitz (1981) which, although void of the usual game-theoretic scaffolding, tried to construct a theory of sovereign debt default and repudiation along the lines of a competitive game played by rivals (debtors and creditors), with strategies, reputational risks, costs, and payoffs. Whereas debt default means an overextended debtor is unable to principal or interest in full when due, debt repudiation means a debtor is unwilling to pay, although he retains some capacity to do so (as such, repudiation carries an extra stigma of the unethical). Eaton and Gersovitz (1981) try to explain why less-developed countries (or LDCs) borrow in the first place, borrow too much, and default; equally, they ask why LDCs nevertheless attract lenders. Sovereign debt defaults were not new in the 1980s; many had occurred already during the Great Depression of the 1930s (Eichengreen and Portes 1986), including by the U.S. (Green 1986). For Eaton and Gersovitz, “a crucial characteristic of [LDC] borrowing is the absence of explicit penalties for non-payment.” There is no higher court to adjudicate, no collateral to seize, and repudiators may “face future exclusion from capital markets,” but rarely a permanent exclusion. Indeed, only by assuming such exclusion can Eaton and Gersovitz assert that “lenders will establish a credit ceiling above which they will be unwilling to increase loans,” as determined by
creditors’ “perception of borrowers’ disutility of exclusion;” if a credit limit is below what a borrower seeks, he is rationed.”(304)

The model in Eaton and Gersovitz (1981) relates credit limits and outstanding debts to “a set of observable borrower characteristics,” mainly export revenues (a key cash source for debt servicing). Echoing public choice insights, Eaton and Gersovitz also assume that “one particular attribute of all [public] borrowers is that they are inherently dishonest, in that they will default if it is to their benefit.” Although there may be no exogenous default cost, lending still occurs because the sovereign borrower, unlike an individual debtor, “optimizes over an infinite horizon in which repayment . . . is a condition for borrowing in subsequent periods.” A maximally safe level of borrowing occurs when “the costs just exceed the benefits of default,” and for debtors, “the benefits of default grow with the size of the outstanding debt.”(290) Cohen and Sachs (1986) likewise interpret a repudiation of public debt as a mere policy “option” for the over-leveraged sovereign, and concur with Eaton and Gersovitz that “repudiation of the debt results in financial autarky and a loss of productive efficiency for the defaulting country,” but also, insist that the “equilibrium strategy of competitive lenders is to make the growth of the foreign debt contingent on the [economic] growth rate of the borrowing country.” Mendoza and Yue (2012) echo Eaton and Gersovitz (1981), as well as Cohen and Sachs (1986), in saying a debt default can be an “optimal decision of a benevolent planner” who calculates a “higher payoff” by defaulting, “even after
internalizing the adverse effects” economically, and knowing it may suffer from “financial autarky.” The next question, of course, is whether autarky is “forever,” or whether, as is likely, the defaulter expects to eventually regain access to foreign credit.

It might be said either that these models lack sufficient realism, or else their creators do not believe it is realistic to expect defaulters and repudiators to regain a ready or affordable access to international credit markets anytime soon after reneging on their debts. Yet many public defaulters did (and do) regain such access. The Latin American sovereign debt defaults of the 1980s confirmed the long-held view that external public debt is riskier and costlier than internally-held debt, and also coined a new adage, to the effect that no international debtor, if he can help it, should commit “original sin” by borrowing in a foreign currency, not one’s own, for the latter, unlike the former, can be printed at will, without limit, to service one’s debts. Yet this latter possibility explains why certain untrustworthy public borrowers can secure foreign funds denominated in their own currency only at high interest rates, and why, instead, they prefer a foreign-currency-denominated loan (given its lower interest rate), although it is also riskier. A work by Kaletsky (The Costs of Default, 1985) appeared in the aftermath of the Latin America debt crises and tried to quantify losses for the sovereign borrower that defaults, and how it may regain its standing in the international credit community; the book gave rise, later, to “Brady Bonds” (named after the U.S. Treasury
Secretary), and the idea that shaky sovereigns in LDCs ultimately needed to be buttressed by more creditworthy and reputable sovereigns (like the U.S.) abroad.

According to Grossman and Van Huyck (1988), sovereign debt defaults, defined as non-payment of interest or principal, tend to be partial, not complete, are usually committed by “identifiably bad states,” and do not indefinitely preclude the defaulting nation from returning to credit markets. Thus the authors incorporate more realism than do Eaton and Gersovitz (1981). As to this last phenomenon – the prodigal debt defaulter, returning to the market in search of new credit – it is notable that the empirics of debt crises recounted in Reinhart and Rogoff 2004, Kohlscheen (2007), and Reinhart and Rogoff (2009) include “serial defaulters,” or nations with checkered histories of excessive debt, followed by default, followed by renewed borrowing, excessive debt, then still further debt defaults. In Grossman and Van Huyck (1988), “sovereign defaults occur as bad outcomes of debt-servicing obligations that are, implicitly, contingent claims,” but lenders “differentiate excusable defaults” from “debt repudiation,” the latter of which harms a nation’s reputation, especially if there is a continuity of governance by the defaulting regime. Unlike private debts, sovereign debts are “above the law,” which by definition exposes public lenders to potentially lawless behavior by the irresponsible public debtor. Indeed, the authors argue, “we can regard the power to abrogate commitments without having to answer to a higher enforcement authority to be the essential property of sovereignty.”
According to Grossman and Van Huyck, since the servicing of sovereign debts cannot be externally enforced, a sovereign that chooses not to repudiate debt does so not altruistically but out of a self-interest in preserving its international reputation for trustworthiness in meeting commitments, which is an asset of long-term and exploitable value; in particular, the sovereign has an interest in fostering a “trustworthy reputation for validating lenders’ servicing,” and with this insight the authors derive what they call “a reputational equilibrium in which the amount of debt and lenders’ expectations about contingent debt servicing are such that the sovereign chooses in all states to validate these expectations, thereby maintaining continued access to loans.” (Grossman and Van Huyck 1988, 1088). Some scholars ask if governments can truly go “bankrupt” (see Rose and Peters 1978), while others advise an international regime for resolving sovereign insolvencies (Scott 2000, Roubini 2000, White 2000). This may be superior to the haphazard, destabilizing oversight typical of the procedures and programs imposed by the IMF or World Bank, yet it resides in the murky realm of international law.

Like Grossman and Van Huyck, Eaton (1996) focuses on the reputational aspects of public debt, or, more exactly, of public credit – pertaining to a sovereign’s credibility or creditworthiness, not merely to its payable debts. Eaton’s model (1996) shows that “sovereign debtors repay debt in order to maintain a reputation for repayment,” and their track record of repayment “gives creditors reason to think that the debtor will suffer adverse consequences if the debtor defaults, so they continue to lend.”
Interestingly, considering today’s debates, Eaton insists that even “a ‘debt overhang,’ while possibly altering credit terms, does not cause profitable investment opportunities to go unexploited.” (25) Recall that Eaton and Gersovitz (1981) had insisted on assuming “one particular attribute of all” public debtors – that “they are inherently dishonest,” and as such, “will default if it is to their benefit.” Yet Grossman and Van Huyck (1988) and Eaton (1996) stress that sovereign debtors also have a self-interest in being honest (although, the more they are, the more they can borrow, which annoys debt pessimists).

Due to numerous public debt defaults in the 1930s, early 1980s, early 1990s, and in the aftermath of the Great Recession of 2009-2011 (see Iceland, Greece), there is now a large body of evidence of public debt defaults available to scholars. An early and systematic effort to develop predictive tools is made in Manasse, Roubini, and Schimmelpfennig (2003), which examines data for LDCs and HIPC (highly-indebted poor countries) that have suffered debt crises (have defaulted on their debts, and were borrowing above IMF quotas), and identifies macroeconomic variables that give early warning of crises. The model accounts for three-quarters of all cases, with few false alarms. The key predictive variables include the external public debt ratio (to GDP), illiquidity (excessive short-term debt), current account deficits, measures of investor confidence, and “political-economy factors leading to policy uncertainty” (including a “high volatility of inflation”). The authors find that nations “with external debt greater
than 50% of GDP are more likely to experience default episodes,” and that default is more likely “if inflation, public debt, and/or external financing requirements are high.”

Many debt-crisis nations borrow in foreign currencies, so debasing their own currencies is no cure but only makes things worse by causing asset-liability mismatches, which reduce financial institutions’ net worth. The authors also address the effects of public debt crises, and conclude that “unlike currency crises, [debt crises] last longer and show persistence,” for “once a country is in [a debt] crisis, it is not easy to get out of one,” nor easy to predict when it will recover, and “even when a country wrangles its way out of a default, the macroeconomic picture is often not as positive as for those countries that have successfully avoided default.”

How do large public debts come to an end? Usually by default, is the answer given in Giordano and Tommasino (2007). They argue that “sovereign [debt] default is the outcome of a political struggle among different groups of citizens,” and is more likely to occur if “debt-holders are relatively few [and] the costs of the financial turmoil . . . are small and concentrated on a tiny fraction of the population.” Obviously, this combination is more likely in majority-rule democracies, but also in nations which, according to the authors, lack “a well-developed financial system” or “independent central bank.” States in such nations permit the majority to exploit the minority (public creditors), exploits the public creditors directly (by defaulting), and exploits, as well, its central bank, compelling it to monetize state bonds. In this study political-financial
institutions matter, for good or ill. “Other things being equal,” the authors find, “the probability of default rests on the institutional characteristics of the country: it is relatively more likely if wealth inequality is high, if constitutional limits to the power of majorities are absent, and if financial markets are underdeveloped.” “Governments which have a poorer constituency will be more prone to default,” for “in a context of underdeveloped financial markets the capital losses on sovereign bonds are mainly incurred by the rich.” In such cases default reflects an animosity towards the rich.

Of special interest are cases when nations default repeatedly (“serial defaulters”), which implies that, despite having a bad credit reputation, nevertheless they repeatedly regain access to credit markets – before defaulting yet again. This puzzle is explained by the fact that such nations often enjoy the backing or guarantees of such non-market, international-financial agencies as the IMF or World Bank, which, in turn, secure funding from taxpayers globally; the result is a degree of moral hazard such that excessive public debt and ultimate default become more likely, not less. Yet part of the explanation also lies in the fact that a “nation” is not synonymous with its government (or its executive administration), unless of course it is ruled for decades by autocrats, as in North Korea or Cuba (in which case, it lacks access to market-based credit). Most nations will have dozens of distinct administrations over the course of a century, some more credible than others.
The more relevant fact, for public debt, is whether a nation can secure some institutional stability and continuity, whether by a constitution with stable provisions that restrict the discretion of a long sequence of distinct administrations over time, whether there exists an objective rule of law or instead an arbitrary rule of men, and whether mechanisms exist to encourage peaceful rather than violent transitions of political power. On this last point, the notion of “odious debt” is relevant (see Jachandran and Kremer 2006), as historically many defaults have occurred when a new government replaces an outgoing one, and whether, driven by ideology or expediency (masked, publicly, as an act of justice or restitution), it refuses to honor the public debts of the predecessor regime, or forthrightly repudiates those debts, even while pledging to potential creditors a faithful adherence to its own future debt contracts.

To understand public debt and its crisis episodes one must understand the political institutions behind it, say van Rijckegehem and Weder (2009). The authors consider both political and economic factors, but find that “political factors matter” most, and “do so in different ways for democratic and non-democratic regimes,” as well as for domestic and external debts. “In democracies, a parliamentary system or sufficient checks and balances almost guarantee the absence of default on external debt,” but “in dictatorships, high stability and tenure play a similar role for default on domestic debt.” Of course, dictatorships rarely exhibit the international wherewithal or credibility (or convertible currency) necessary to secure foreign credit in the first place; nonetheless,
autocrats are usually conscientious about paying their domestic debts, because they have longer tenures in office and no electrical motive to secure popular support by borrowing too much (i.e., deferring taxes to successor regimes or future generations).

As to “serial defaulters,” Reinhart and Rogoff (2004) contend that “throughout history, governments have demonstrated that ‘serial default’ is the rule, not the exception,” and not only in Latin America (Argentine, Brazil, Mexico, Venezuela), but also in Europe (France, Germany, Portugal, Spain). On the other hand, no public debt defaults have occurred in India, South Korea, Malaysia, Singapore or Thailand, despite occasional and severe turmoil (e.g., the currency crises in Southeast Asia in 1997-1998). Reinhart and Rogoff doubt claims that default patterns are random and unpredictable, especially when defaults “recur like clockwork in some countries.” Nor do they believe it is “paradoxical” that capital tends not to flow (on a net basis) from richer to poorer nations; on the contrary, they argue, “too much capital (specifically in the form of debt) is channeled to ‘debt-intolerant’ serial defaulters,” and the fault lies, they say, in “government and government-guaranteed external debt.” (Reinhart and Rogoff 2004, 53)

The notion of “debt intolerance” had been introduced in Reinhart, Rogoff, and Savastano (2003), with a specific, analogous reference to “lactose intolerance,” hence the hint that something persistent and constitutional makes certain nations repeatedly renege on their public debts. The bigger question is why serial defaulters keep finding new lenders (victims); the authors attribute this to lenders’ over-optimism during
booms, but “borrowing countries themselves are complicit in the problem,” because “throughout history, governments have often been too short-sighted (or too corrupt) to internalize the significant risks that over-borrowing produces over the longer term.” (Reinhart, Rogoff, and Savastano 2003, 4-5).

Considering the pattern of serial defaulting, Reinhart and Rogoff (2004, 57) suggest that “emerging-market countries may need to aim for far lower levels of external debt-to-GDP [ratios] than what has been conventionally considered prudent. Indeed, prudent external-debt thresholds may be closer to 15-20% (the level seen in several of the defaulters) than the much higher levels today [that] one sees.” Recall how Manasse, Roubini, and Schimmelpfennig (2003) argue that public debt default is more likely by nations that exhibit “external debt greater than 50% of GDP.” Reinhart and Rogoff advise a still-lower threshold.

The importance of institutional structures and incentives (for good or ill) in the pattern of “serial defaulters” is stressed by Kohlscheen (2007). He finds that presidential democracies are five times more likely to default on their external public debts than are parliamentary democracies; an explanation for serial defaulting “lies in their constitutions.” He notes how, over the course of 180 years, Venezuela and Mexico defaulted on their external debts nine and eight separate times, respectively, yet in that same time India, Malaysia, and Thailand never defaulted. All else equal, parliamentary democracies default less, he says, because the near-continuous possibility of a
“confidence” (or “no confidence”) vote “creates a credible link between economic policies and the executive’s survival,” and this link “tends to strengthen the repayment commitment when politicians are opportunistic.” In presidential democracies the executive does not require the continuous consent of the legislature, and this makes the executive less prone to meet debt commitments. Kohlscheen’s conclusion runs counter to prior research, which insists that defaults are more likely in systems of proportional representation, with parliaments and unstable or unworkable coalition governments that lack a unified political capacity or will.

The crucial distinction between political capacity and political will, in general, relates closely, as well, to the specific capacity or will to service public debts. Already we have distinguished between a public debt default, in which a government only lacks the capacity to repay, and a debt repudiation, in which it lacks a willingness to repay, even when it appears to have a capacity to repay. Tomz and Wright (2007), in their study of public debt default history (1820-2004), hypothesize a link between economic output and default. It seems only reasonable to expect to find public debt defaults occurring not in prosperous times but in “bad times,” which the authors define as cases “when output was relatively low.” Yet they find many cases in which states have “suspended [debt] payments when the domestic economy was favorable,” and many others in which governments “have maintained debt service in the face of adverse [economic] shocks.”
Obviously, factors less-quantifiable than debt ratios, capital flows, political coalitions, or electoral affiliations exert an important influence on public debt accumulation, service, and defaults, and as such must be incorporated in any valid theory of public debt. Panizza, Sturzenegger and Zettelmeyer (2009) concur on this point, on the need for analytical balance, although their focus is almost exclusively on the legal-institutional aspects of public debts and defaults, that is, on “the evolution of the legal principles underlying the sovereign debt market and the experience of the most recent debt crisis and defaults.”

Financial-economic data, regressions, and prisoner games alone are inadequate to the task at hand. On this point Wright (2011) provides a useful overview of the non-technical yet nonetheless crucial aspects of the problem, of “the forces that encourage repayment of sovereign debt when legal enforcement is ineffective” (and frankly, given the lack of a one-world government, inapplicable too). Yet he laments that economists cannot pinpoint the costs of default to the defaulter, and how this impedes globalization.

In the final analysis, character, reputation, ethics, institutions and other difficult-to-measure factors must play an important role in any realistic theory of public debt incurrence, tolerance, and service. The more political economists observe, realistically, what actually happens in this realm, the more likely they may discover that the political matters as much (perhaps more) than the economic – or put another way, the more likely they may acknowledge that public debt theory must be concerned as much with the
public (political) as with the debt (economic) part of the story. If so, the public choice approach seems to enjoy an analytical advantage over other less-integrated approaches, committed as it is to investigating all crucial happenings at the busy intersection of politics and economics. Other approaches, in contrast, focus excessively on politics to the neglect of economics, while others focus on economics to the exclusion of politics. Public choice perceives why the one cannot be fully understood absent the other.

Kolb (2011) goes so far as to classify public debt as “a pivotal factor in world affairs,” noting that nations tend to rise or fall, historically, depending not only on their military capacity and prowess, but also on their financial capacity and prowess, which entails their borrowing (credit) capacity and prowess. In August 2010 U.S. Admiral Mike Mullen, chairman of the Joint Chiefs of Staff, designated the U.S. federal debt “the single biggest threat to national security,” noting that interest expense had begun to match and might soon surpass annual defense spending. Mullen’s warning was subsequently echoed by U.S. Defense Secretary Leon Panetta, U.S. Secretary of State Hillary Clinton, GOP vice-presidential candidate Paul Ryan, and various other leaders in Washington. Hyperbole aside, even if a large national debt were not such a threat to a nation’s security and future, the fact that political elites believe it is can drive their behavior.

By now we have examined contemporary theories of the origin and persistence of public debt, theories of “optimal” levels (and ratios) of public debt, theories of why public debt may become excessive (and how best to measure this), and the theory of
public debt defaults. Finally, we now turn to the most recent empirical studies of the aftermath of high public debt levels and actual debt defaults.

Recall that Reinhart, Rogoff, and Savastano (2003) develop the concept of “debt intolerance,” while Reinhart and Rogoff (2004) develop the concept of the “serial defaulter.” These concepts help us better understand the vast empirical record gathered in *This Time is Different: Eight Centuries of Financial Folly* (Reinhart and Rogoff 2009), and closely-related follow-up works (Reinhart and Rogoff 2010, Reinhart and Rogoff 2011a, Reinhart and Rogoff 2011b, and Reinhart, Reinhart, and Rogoff 2012). *This Time is Different* (Reinhart and Rogoff 2009) is billed as a survey of eight-centuries of public debt experience, but its focus is mainly on the past two centuries (since 1800), and within that, primarily on the failed part of the history (public debt defaults). For a more balanced account, not only of the good and the bad history of public debt, but also of the political background and the actual market yields on sovereign debt, the best single source remains Homer and Sylla (1991).

Reinhart and Rogoff (2009) covers sixty-six countries over two centuries, and lists 320 distinct cases of public debt default, the bulk of which (250) pertain to externally-owed public debt, while the balance (70) pertains to domestically-owed debt. Quantitatively, the authors focus on the ratio of the nominal (face value) of gross public debt (i.e., all debt issued by a central or federal government, not the debt of sub-states or local units) relative to a measure of national income (nominal GDP) – hereafter, simply
“Debt/GDP.” In addition to providing tables and narratives for the major debt defaults, while distinguishing advanced nations from less-advanced ones (or, in 1970s parlance, “less-developed countries,” or LDCs), Reinhart and Rogoff (2009) try to associate, contemporaneously, Debt/GDP ratios with default rates and economic growth rates.

The main finding of Reinhart and Rogoff (2009) is that Debt/GDP ratios of 60% or less are safe and innocuous: they neither detract from economic growth rates nor raise the likelihood of a public debt default. In contrast, Debt/GDP ratios above 60% are troubling for LDCs, while ratios above 90% are troubling for advanced nations. By “troubling” the authors’ mean that above these threshold ratios, economic growth rates tend to be lower, while debt default rates tend to be higher (all calculated on a contemporaneous basis). Notably, the relationship is non-linear; there is no steady deterioration in either an economy or a government’s creditworthiness as the debt ratio climbs upwards to 60% for LDCs, or upwards to 90% for advanced nations; then, apparently, all hell breaks loose only after these dual thresholds are breached, respectively, in these two distinct nation types.

On the possibility of identifying some non-linear breakpoint for public debt defaults, Reinhart and Rogoff (2009) believe there exists a latent “financial fragility in economies with massive [public] indebtedness,” that “all too often, a period of heavy borrowing can take place in a bubble and last for a surprisingly long time.” Nevertheless, highly-leveraged economies, particularly those in which continual
rollover of short-term debt is sustained only by confidence in relatively illiquid underlying assets, seldom survive forever, particularly if leverage continues to grow unchecked. This time may seem different, but all too often a deeper look shows it is not.” (Reinhart and Rogoff 2009, 292). In a mid-2010 essay on the presumed non-linear relationship between public leverage and default, and the seeming paradox that the U.S., despite a record-high peacetime leverage ratio (97% at the time), was paying a lesser bond yield (3% at the time) than previously (5% in mid-2006), Rogoff, writes as follows:

The fact that the markets seem nowhere near forcing adjustment on most advanced economies can hardly be construed as proof that rising debts are riskless. Indeed, the evidence generally suggests that the response of interest rates to debt is highly non-linear. Thus, an apparently benign market environment can darken quite suddenly as a country approaches its debt ceiling. Even the U.S. is likely to face a relatively sudden fiscal adjustment at some point if it does not put its fiscal house in order (Rogoff 2010).

That Rogoff, in this, passage cites a U.S. “debt ceiling” is both revealing and ironic, because he is referring not to the purely artificial-legislative U.S. debt limit which would become a point of heated, partisan contention in Washington more than year later (in mid-2011), but rather to the theoretical-imaginary 90% ceiling that he and Reinhardt would infer from their empirical investigations. (Reinhart and Rogoff 2009) Although the legal U.S. debt ceiling was finally raised in August 2011, the lengthy partisan battle surrounding the move motivated Standard & Poor’s to reduce the U.S. debt rating by a notch, from its highest possible rating, for the first time ever. Lower ratings are intended to suggest extra risk, and investors supposedly respond by demanding higher yields.
But during the debt limit debate and downgrade U.S. bond prices skyrocketed as yields plunged. A year later, in August 2012, the Debt/GDP ratio was even higher (105%) and the 10-year Treasury bond yield was even lower (1.70%).

Whereas the studies presented in Reinhart and Rogoff (2009) and in Reinhart and Rogoff (2010) are restricted to exploring the \textit{contemporaneous association} (correlation) between a nation’s Debt/GDP ratio and its history of default and economic growth, the effort made in Reinhart and Rogoff (2011) is to demonstrate how abnormally high Debt/GDP ratios (60%+ for LDCs, 90%+ for advanced nations) tend to presage multi-year future periods of economic stagnation. This theme, with additional supporting evidence, is developed even more fully (and for advanced nations only) in Reinhart, Reinhart, and Rogoff (2012), which is notable also for its use of the concept of a “debt overhang.” This concept might also (and more memorably) be construed as a drinking-binge hangover, since Reinhart and Rogoff seem to liken episodes of stagnation to the day of inevitable suffering after a wild party, as market-makers and policymakers previously “become too drunk with their credit bubble-fueled success.” (Reinhart and Rogoff 2009, 292)

In none of their works, to date, do Reinhart and Rogoff speculate about (or test for) possible causes of the empirical link that exists between high Debt/GDP ratios and economic stagnation (or default), regardless of whether the link is contemporaneous or else lagged. So far, theirs is mainly an empirical-historical exercise, albeit crucial as a preliminary, inductive foundation for a subsequent theoretical treatment. But we can
suggest a few reasonable hypotheses about causes of the link. First, it may be due to the higher interest rates that tend to accompany higher public leverage (and undermine economic growth); second, public interest expense may grow so high, relative to other budget categories (notably, infrastructure), as to displace them, and in ways that sap the economic growth rate; third, policymakers might narrow huge budget deficits by growth-curbing “austerity” plans (higher taxes, lower spending).

Some constructive criticism is in order on Reinhart-Rogoff studies of public debt. First, correlation is not causation. A rising Debt/GDP ratio may have less to do with higher borrowing (numerator) than with lower growth (denominator); in other words, it may not be higher public leverage that is slowing economic growth, but slower growth that is boosting leverage. Second, the studies do not adequately incorporate leverage in the private (and especially financial) sector, nor discuss how private debts are often a contingent liability of government, and worse, one that can become all-too-tangible, all-too-quickly, in a financial crisis, especially amid pledges made, ex ante, to provide bailouts. Third, the studies omit measures or discussions of the large, “off-balance sheet” obligations associated with unfunded (or underfunded) “entitlement” programs, even though these often dwarf the size of publicly-traded debt. Finally, results for some nations may lack the requisite robustness. As just one example, Reinhart and Rogoff (2009) include 216 data points for the U.S., but only 5% of these involve a Debt/GDP ratio lying near or above the supposedly crucial threshold of 90%.
Consequently their broad theme about public debt – based as it is on the leverage and default rates of sixty-five other nations over two centuries – may not be legitimately extendable to important cases like the U.S., or for that matter, to Japan. Notably, in the U.S. and Japan leverage ratios are above 100%, yet public bond yields are below 2%.

The Reinhart and Rogoff studies also treat nominal GDP (the denominator in Debt/GDP ratios) out of context, forgetting that two nations with a similar level of GDP (or Debt/GDP ratios) nevertheless may have dramatically different statistics relating to each economy’s taxable capacity, level of interest rates, economic growth rates, or share-of-budget devoted to interest expense, each of which could mitigate or else intensify a particular public leverage ratio. For example, a higher leverage ratio in an economy with a greater but less-used taxable capacity is less precarious than a lower ratio in a rival economy where taxable capacity is exhausted.

Although the above-mentioned shortcomings in the Reinhart-Rogoff studies are not unimportant, and can probably be repaired upon closer investigation, of greater and more fundamental importance is a fifth objection – that their studies generally ignore, or else do not find relevant, prevailing monetary regimes. Yet these are crucial to understanding public debt, as discussed below. The problem is not that Reinhart-Rogoff do not cite or discuss inflation, or are unaware that it is a component of nominal GDP (the all-important denominator in their Debt/GDP ratios), and thus that it can, consistent with their own logic, rise to rates that lower debt ratios and thereby lighten public debt
burdens; the real problem is that they fail to adjust or at minimum qualify their otherwise dire conclusions about “excessive” public debt by bringing money and inflation more directly and formally into the analysis. Two concepts are crucial in this regard – “exorbitant privilege” and “original sin” – as we discuss next.

6.4 “Exorbitant Privilege,” “Original Sin,” and “The Paradox of Profligacy”

Three phenomenon are crucial to understanding how the contemporary (post-1971) fiat-money regime is deployed by sovereigns to disguise and mitigate their debt burdens: “exorbitant privilege,” “original sin,” and “the paradox of profligacy.”

As recounted and analyzed at greater length in Eichengreen (2011), “exorbitant privilege” – a term coined in the 1960s by French Finance Minister Valery Giscard d’Estaing – refers to the special advantage enjoyed by a sovereign whose national currency is that which, more than others, is held globally by a majority of central banks as backing for their own currencies (and in some cases, further circulates as a transaction medium in a foreign economy). Giscard d’Estaing was complaining that the U.S. was unduly exploiting the dollar’s status as a reserve currency. The key benefit of the “privilege” is that it permits the reserve-currency issuer to generate excessive sums of its own money (excessive relative to the real needs of trade) without suffering the usual result of such excess, namely a higher inflation rate. This is possible because a reserve currency, by its nature, purpose and usage, tends to be in greater global demand compared to demand for other (non-reserve) currencies.
By the law of supply and demand, an enlarged supply of any currency which is met by an equally-enlarged demand to hold and use it, will tend to retain its value (real purchasing power), relative to the value of currencies that also are issued liberally but are less demanded. Since a reserve currency is in great demand globally, it is also less prone to suffering from inflation, or a loss of purchasing power, even when liberally supplied. The “exorbitant privilege” enjoyed by the sovereign issuer of a reserve currency permits it to acquire real resources virtually without limit (as long as the money’s purchasing power holds up), but even if not without limit, nevertheless to a greater extent relative to other currency issuers.

A reserve currency need not comprise the entirety of central bank reserves globally, only a large majority of them. There is a subtle, reciprocal aspect to the process by which a currency becomes a reserve asset in the first place and then sees its status preserved or even extended over many subsequent decades. A currency’s reserve status is initially established and achieved when the currency comes to be more trusted globally, and hence more demanded for its capacity to hold its value (purchasing power), to a steadier degree, over longer periods of time, than other currencies; as such it also becomes the most liquid and easily-traded currency, a further valuable attribute which further boosts the demand for it. A currency then retains its reserve status in part because of inertia, in part because it is the established norm, but most importantly, because it continues to hold its value. If for whatever reason these crucial properties no
longer apply, whether in whole or in part, the reserve currency will begin to lose its value and reserve status and with it, of course, the privileges, benefits, and immunities pertaining therein.

Crucially, for our present focus, which is the monetary aspects of public credit and debt, any degree of “exorbitant privilege” enjoyed by the sovereign which issues the world’s reserve currency tends to extend also to its debt securities. Typically a central bank’s foreign cash reserves are not left idle but instead are invested (or reinvested) in the debt of a reserve-currency nation, partly for convenience, as the debt is usually denominated in the reserve currency, and partly out of self-interest, for the same factors that render a reserve currency safe and attractive also tended to make the public debt of a reserve currency issuer safe and remunerative. In short, if a sovereign’s currency is trusted, so also will its public debt be trusted. In effect, a derived demand arises for the public debt of the sovereign issuer of a widely-held reserve currency; as long as the reserve currency is widely-demanded, as it is by definition and function, so also will the public debt denominated in that currency be widely-demanded. And just as the law of supply and demand ensures that the value of a sovereign’s reserve currency will be preserved even amid an enlarged issuance, as long as it is matched by an equally-enlarged demand to hold the newly-issued currency, so the law likewise ensures that the value of a sovereign’s public debt will be preserved, even amid an enlarged issuance, as long as it is met by an equally-enlarged demand to hold the new debt.
If one mistakenly consults only the additional supplies of money or public debt, without at the same time considering potential changes in the demand to hold each, empirical records can seem paradoxical, especially amid dramatic supply shocks that seem to involve no plunges in price or value. For example, the U.S. money supply (measured by M-1) increased by 88% in the decade ending 1982 and by 99% in the decade ending 2012, but whereas prices (measured by the GDP Deflator) increased by 109% in the first case (1972-1982), or 21% points faster than the monetary growth rate, they increased by only 25% in the second case (2002-2012), or 74% points slower than the monetary growth rate. We can only infer that in the latter decade, although the supply of dollars increased dramatically, by 99%, nevertheless the demand for that supply must have risen more so, since prices increased by only 25%.

Likewise, with U.S. Treasury securities, lesser increases in their supply have, paradoxically, accompanied declines in their price (increases in yield), while in other, equally paradoxical cases, large increases in bond supply have entailed increases in price (lower yields). In the first case the new bond supply was moderate, but demand was weaker still; in the latter case, although bond supply skyrocketed, so did the demand for the bonds, and more so. For example, the U.S. federal debt increased by only 30% in the decade ending 1970, yet the 10-year Treasury bond price plunged by 27% in that period, as its yield jumped from an average of 4.12% in 1960 to 7.35% in 1970. In contrast, U.S. federal debt skyrocketed in the decade through 2012, from $6.4 trillion in 2002 (60% of
GDP) to $16.1 trillion in 2012 (105% of GDP), yet the price of the 10-year Treasury bond skyrocketed, by 105%, as its average yield plunged from an average of 4.61% in 2002 to just 1.83% in 2012. In the first case a moderate rise in bond supply was met by a diminished demand to hold such bonds, so their price declined; in the latter case, despite a huge rise in bond supply, a still larger rise in the demand for it raised its price.

The latent, strong, worldwide demand that seems always to await the issuance of a long-established reserve currency, and as well the public debts denominated in such currency, can become even more intense amid financial crises, when investors flee less-trusted currencies and less-creditworthy sovereign bonds, and try to become more liquid; in so doing, they participate in a “flight to safety,” or “flight to quality,” which entails a relative shift in demand toward the reserve currency, away from other currencies, and thus also a shift in demand for reserve-currency bonds, away from other bonds. This phenomenon also may explains the paradox that in crises, as budget deficits widen and public debt levels (and Debt/GDP ratios) soar, nevertheless certain sovereign bonds exhibit a plunging yield and rising price; but this occurs mainly for sovereign debtors who enjoy an “exorbitant privilege.” Of course, sovereigns that lack “exorbitant privilege” – whether because their economies (and imports) are too small to generate a supply currency sufficient to meet the demands of central banks around the globe, or whether they are big enough but the currency they issue is not trustworthy – cannot enjoy the same kind of low bond yields that reserve-currency public debtors enjoy.
Under the classical gold standard (1870-1913), gold itself, not any fiat paper currency, was the main monetary reserve for the world’s sixty-or-so redeemable currencies. Some scholars have likened this regime to one that institutionalizes a “Good Housekeeping Seal of Approval” (Bordo and Rockoff 1996). Others extend the argument to say a currency, in order to be a truly “credible currency” must not be issued by mere fiat, or decree, but instead under an exogenous, rules-based constitutional constraint of some kind (Dove 2012), which may include a gold standard (Selgin and White 2005). A sovereign signals its integrity and commitment to good-faith dealing with market users and holders of its currency (and bonds) by pledging to redeem its currency, in a fixed weight of gold, on demand; *ex ante*, its rescinds any “right” to break its contract by debasing its money. Other scholars have shown how this monetary commitment tended to worked better amid the purer classical gold-coin standard of 1870-1913 than it did under the more diluted gold-bullion standard manipulated by politically-motivated central banks in the late 1920s (Obstfeld and Taylor 2003).

In the case of the U.S., which defaulted on both its gold-redeemable dollar and its gold-based bonds, in 1933, Green (1986) concludes that, despite centuries-long precedent, after 1933 “the power of governments in general to debase their currencies is firmly established,” and “an important part of that power is the ability to prevent private agents from taking action to insulate themselves from the effects of such policy.” (Green 1986, 14) Indeed, the U.S. abrogation of 1933 was accompanied by an equally-
unprecedented seizure of private gold stocks and a criminalization of private gold holding that would not be rescinded until 1975, a few years after the third abandonment of a gold-based dollar, this time in the form of the gold-exchange standard of the Bretton Woods regime that lasted from 1948 to 1971.

A century ago, on the precipice of World War I, when the British pound was the world’s most trusted currency, in part due to London’s large role in the financial system, but due mostly to the fact that over the prior two centuries (excepting 1797-1821) the pound was unquestionably redeemable in gold, worldwide, the pound itself served as the world’s main reserve currency. In 1914, with the pound as the world’s main reserve currency, Britain enjoyed an “exorbitant privilege.” Yet World War I began a long-term process of displacement of the British pound, as the world’s main reserve currency, by the U.S. dollar, a process which spread and intensified under the Bretton Woods gold-exchange system (1948-1971). In that monetary regime only the U.S. dollar was defined as a fixed weight of gold (at 1/35th an ounce), and redeemable only to central banks abroad (not to individuals); only central bankers could demand gold from the U.S. Treasury, in exchange for dollars held. Under Bretton Woods most foreign central banks refrained from demanding gold from the U.S. (the Bank of France excepted), and simply held dollars in their own vaults, invested in U.S. debt securities, as backing for their own national currencies. Despite the abandonment of the Bretton Woods system in 1971, the U.S. dollar has since retained its reserve-currency status, although it is no longer the
only currency used for that purpose; it now comprises 65% of foreign central bank currency reserves.

As mentioned, in the 1960s French Finance Minister Giscard d’Estaing complained that the U.S. was exploiting the dollar’s reserve currency status. During that decade the Bank of France was one of the few foreign central banks in the Bretton Woods system that exercised its right to redeem dollars for gold, but as it did so, and as it was joined by others, the U.S. official gold stock was halved, a depletion that so worried U.S. finance officials that in 1971 they unilaterally terminated U.S. participation in the system. The fact that no currency in the world since 1971 has had any formal tie to gold does not negate the basic principle of “exorbitant privilege” and the ways it benefits the nation that issues and borrows in a reserve currency. In the century through 1914 the advantage was all Britain’s. In the past century the advantage has been all to the U.S. Over the coming century the advantage may shift to China. The irony of reserve currency status is that it is typically earned by decades of monetary trustworthiness and fiscal rectitude, but once attained, is prone to being exploited politically, by such deliberate polices as monetary inflation and deficit-finance, such that the status is lost to a rival sovereign that for a few decades at least has itself come to earn a monetary trustworthiness and to practice fiscal rectitude.

A second, but closely-related principle states that a sovereign best insures against explicitly defaulting on its public bonds not so much by any sustained commitment to
fiscal conservatism (although that may help) – whether defined as spending restraint, minimal deficit-spending, or the maintenance of a low-to-moderate Debt/GDP ratio – but simply and solely by ensuring that it only borrows in its own currency. Putting the point negatively (as is typical of the literature on this topic), the same principle can be stated thus: a sovereign should never commit the “original sin” of borrowing in the currency of any other sovereign, that is, of pledging to repay its debts in a monetary medium it has no right to print at will. (see Bordo, Meissner and Redish 2003; Eichengreen and Haussmann 2004; Eichengreen, Haussmann and Panizza 2007) As long as a sovereign issues an irredeemable fiat-paper currency, as most have since 1971 (after the dissolution of the Bretton Woods gold-exchange system), that sovereign can, without question or exception, service any debt it incurs, no matter how large it may be, as long as the debt is denominated in the currency it alone issues (as a monopolist). To service its debts in full, it need not cut spending, raise taxes, narrow deficits, or lower its debt ratio; it need merely print (or create electronically) the money it requires.

Whereas the principle of “exorbitant privilege” states that a sovereign issuer of a reserve-currency gains an advantage that extends also to its issuance of reserve-currency public bonds (at lower yields than otherwise would be possible), the principle that it should avoid committing “original sin” in the process only adds the point that, given its reserve-currency status, it has another good reason not to borrow in the currencies of
other sovereigns; but the admonition against committing the sin holds true for every sovereign that lacks the privilege of issuing a reserve currency.

The fact that most sovereigns tend to borrow in their own currency does not thereby guarantee that they will borrow at low, affordable yields; if the currency they issue is not well-trusted, it will not be well-demanded, and if it is not well-demanded, it will lose value, all else equal, and if a currency loses value, so also will the value of bonds denominated in that currency. In turn, bonds that lose value decline in price, which means their yield increases. That an expansionary monetary policy might lower bond values is but another way of saying it can lessen the sovereign’s debt burden (indeed, the debt burdens of all parties that borrow, including those in the private sector). When public debt management is coupled with a deliberate, state-sponsored policy of inflation, or public debt monetization – which the literature characterizes as “inflationary finance” – the inflation entails not an explicit but an implicit debt default.

Reexamining the work and conclusions of Reinhart and Rogoff on public debt history, debt defaults, and their aftermath (2009, 2010, 2011a, 2011b), in the light of a refreshed understanding of “exorbitant privilege” and “original sin,” we can now say, with greater specificity and more constructively, that the defects in their data collection and interpretations derive mainly from a general neglect of these monetary principles. Put another way, their work on public debts is incomplete and partly misleading, because it omits the complicating and mitigating role of public currencies. Both public currency
and public debt exist on a continuum: 1) currency, or non-interest-bearing paper that both circulates and serves as bank reserves, and is jointly issued by a sovereign’s treasury department and central bank; 2) treasury bills, or short-term (due in less than a year) lower-interest-bearing obligations of the sovereign; 3) treasury notes, or medium-term (due in 1-10 years) moderate-interest-bearing obligations of the sovereign; 4) treasury bonds, or long-term (due in 10 years or more) higher-interest-bearing obligations of the sovereign; and 5) entitlements, or generationally-long term, non-interest-bearing political promises of benefits, in the future, to pensioners, patients, the disabled, bondholders of failed industrial companies, or depositors of failed banks.

The first sovereign obligation, currency, obviously can be issued without limit, since 1971 – but this point is neglected in the work of Reinhart and Rogoff. In seeking to explain two centuries of public debt defaults covering every imaginable variety and context, they come to insist that the key and uniform factor of importance for any sovereign is its Debt/GDP ratio, regardless not only of each economy’s distinct taxable capacities, but more importantly, regardless of the monetary regime. First, Reinhart and Rogoff concede that their posited relationship lacks linearity, such that a rising debt ratio does not necessarily coincide with a rising probability of default, and although that alone entails no inherent defect of analysis (not all relationships need be linear to be either interesting or valid), but in addition they insist that the default-inducing threshold for Debt/GDP tends to be 60% for less-developed nations and 90% for “advanced
nations,” without really knowing (or saying) why that might be. Nor can they explain such aberrations as petty and serial defaults even amid low debt ratios, or better still, no defaults amid bottom-basement yields in high-leverage cases, like Japan since at least 2001 (and now, more recently the U.S.). Reinhart and Rogoff believe they present the plain data, raw, true and unvarnished, but in fact they also inject hyperbolic narration and fail to include, or even discuss at any great length, such relevant data as public debt yields and monetary regimes, the first of which is market evidence of default risk, the latter of which can more easily and distinguish default from non-default experience.

By omitting any systematic characterization of the distinct monetary regime by which any sovereign has operated over the past two centuries, whether unilaterally or in tandem with other sovereign, Reinhart and Rogoff omit a major explanatory variable. They fail to acknowledge various possible (and actual, historical) interactions between monetary and debt regimes which can significantly heighten or instead diminish the all-important role of public leverage (the Debt/GDP ratio), at least at levels above 60% (for less-advanced nations) and 90% (for advanced nations). For example, their studies make no distinction between default episodes that occur under versions of the gold standard, when sovereigns’ monetary discretion is restrained, or those that occur in cases where fiat paper currencies are pegged to other ones, or those that occur when all currencies are on fiat-paper basis and are issued without any effective limit, as in the post-1971 decades. As such they also fail to recognize the many important cases where “exorbitant
privilege” and “original sin” operate, and generate significant, seemingly paradoxical results in public debt history.

By not incorporating monetary regimes into their account of public debt history, Reinhart and Rogoff are unable to explain as much as they could, and misinterpret more than is necessary. Consider, at one extreme, how a sovereign’s hands might be tied monetarily, as under a gold standard, or in a system of pegged, fiat-paper-money exchange rates; instead of enjoying discretion, a sovereign is subject to rules, but even so, and despite a low Debt/GDP ratio, it might be more likely to default on its debts than less, if its fiscal house is in disorder and it cannot bail itself out by resort to a monetary printing press. At another extreme, even the sovereign that shoulders a large Debt/GDP ratio may easily service its debts, as long as its monetary hands are free and it can issue, without effective limit, more of the currency in which it has borrowed, whether because, as a reserve-currency issuer, it enjoys an “exorbitant privilege,” or, if it does not, at the least has not committed the “original sin” of borrowing in another sovereign’s currency, or denominated its debts in a currency which it cannot print.

If, indeed, a sovereign enjoys exorbitant privilege, not only will it more likely than not service even high debts with relative ease, but should be able to do so at low interest rates, and, in crises settings, in a context of declining interest rates, such that it can refinance its high debts at a successively-lower cost. This has been the experience of the U.S. over the past decade; even as it borrows dramatically more in absolute terms,
and relative to GDP (from 67% in 2008 to 105% in 2012), nevertheless it does so at ever-lower interest rates. In a nearly opposite case, Greece defaulted in 2012, not so much because its leverage was high, though it was, but because in 1999 it had jettisoned its own currency (the drachma) in order to join the euro, and could not immunize itself from the global financial crisis of 2008-2011. Greece’s Debt/GDP ratio had been fairly level, at just 100-110% (close to the U.S. ratio in 2012) for fifteen straight years, 1994-2008, but it jumped dramatically from 113% in 2009 to 130% in 2010, to 148% in 2011 and then to 171% in 2012, second in the world only to Japan’s ratio of 212% (up from 167% in 2008); but whereas Greece’s debt yield jumped from 4% in 2009 to 44% in 2012, before it defaulted, Japan’s yield has averaged less than 1% in 2011-2012. Unlike Japan, in 1999 Greece surrendered its right and power to its issue its own currency (the drachma), and then, unlike other euro-zone sovereigns, failed to better diversify or immunize itself from financial crises. When Greece borrowed in its own currency (drachma), from 1971 to 1990, it never explicitly defaulted on its debt, although it did inflate the currency. While on the gold standard, it occasionally defaulted on its debt, because thereby it had subjected itself to monetary limits, but not to any meaningful deficit-spending limits.

It is significant, regarding the argument for including monetary regimes in public debt analyses, that Reinhart and Rogoff’s database of defaults contains no clear case of any sovereign defaulting on its debt explicitly when, at the same time, it freely issued its own money and borrowed only in the currency. What the authors do not
convey, explicitly, is that such a case does not happen because, put simply, it need not happen; that is, there is no economic or political advantage in it. Implicit default by inflation is easier, less visible and generally uncontroversial. This is not to argue, normatively, that such a policy should be enacted; it is only to note that such policy is enacted, and frequently, because there is political advantage in it. Politicians prefer implicit to explicit debt defaults, and economists make it easy for them to do so, since economists view inflation as indispensable to a well-oiled, well-functioning economy.

Public debt scholars have no firm basis for worrying or predicting that such a policy might be displaced by explicit default. Indeed, most cases of public debt default in Reinhart and Rogoff’s studies occur not because the public debtor is heavily-leveraged (with a high Debt/GDP ratio) but because it is not an issuer of a reserve currency, or because it does not have wide monetary latitude, or because it borrows in another sovereign’s currency. If less-developed nations have higher default rates than advanced nations, it is not primarily because they are more leveraged, as Reinhart and Rogoff imply, or because they rely more on externally-held than internally-held debt, as they also imply, but because such nations suffer occasional mismatches between the debt they owe and the money they issue.

Disputes about the best means of measuring a public debt burden or default risk are relevant to forecasting and policymaking. If it is supposed that only public leverage ratios matter, or that ratios of 90% or higher inexorably signal trouble, misguided
forecasts of pending default may elicit popular but misguided calls for austere fiscal policy, including tax hikes which, if enacted, might make matters worse.

Having examined critically the path-breaking empirical work of Reinhart and Rogoff, and the implications of their neglect of the crucial role played by monetary regimes, we are now in a position to better comprehend a phenomenon we call “the paradox of profligacy,” which is this: deficit-spending sovereigns that are more leveraged than others (exhibiting higher Debt/GDP ratios), and thus presumably riskier as credits, nevertheless are observed paying lower interest rates than more fiscally-conservative sovereigns; even over time, we can observe sovereigns as a whole assuming successively greater leverage while simultaneously paying successively lower interest rates on their bonds (see Table 3, Chapter 2, “The Paradox of Profligacy: Higher Public Debt Leverage Yet Lower Borrowing Rates, G-7 Nations, 1980-2010.”)

The seeming “paradox” can be put in the form of a question: Why are the more-profligate public deficit-spenders and borrowers – the more indebted, the more-leveraged, the riskier – paying not higher interest rates, or even the same rates as previously, but rather, lower ones? Since the reverse pattern prevails in private credit markets, perhaps the paradox is explained by the fact that, despite the classical-school presupposition, there is no strict analogy between public and private debtors. Alternatively, the notion of a paradox itself might be jettisoned on the ground that it assumes its own conclusion; perhaps sovereigns with higher leverage are not, in fact,
fiscally reckless or profligate at all, precisely because rational, self-interested markets do not charge them accordingly; if public creditors are charging risky public debtors interest rates that seem more fit for safe public debtors, perhaps the “risky” ones are not so risky in fact; perhaps even the highly-leveraged public borrower can be classified, for whatever reason, as yet to be discovered, as a safe borrower.

But why? If it is true that seemingly risky public debtors are not in fact risky, given the hard-headed evidence embedded in the market prices charged by profit-maximizing Wall Street sophisticates and professionally-operated private pension funds (i.e., the typical buyers, traders and holders of public bonds), then the public debt pessimists are wrong, have nothing to worry about, and should be met with skepticism and, in the policy arena, with opposition, if they seek to rectify their imagined non-problem with economy-crushing fiscal “austerity” plans. On the other hand, if the paradox of profligacy is true, in the sense that highly-leveraged public borrowers should be paying higher interest rates but are not doing so for wholly artificial or perhaps political reasons (say, with the aid of central bank policy or regulations that impose “financial repression,” of which, more below), then the debt optimists may be wrong.

At some point, it may be argued (by debt pessimists), artificially-low public bond yields will rise to reflect the true state of affairs (excessive debt, unsustainable leverage, pending default), and indeed may rise precipitously, back to more normal (historical) levels, which by definition means public bond values (prices) will plunge, which means,
in turn, that financial institution the world over will collapse and become insolvent \textit{en masse}, precisely because they too are highly leveraged and they, more than any other sector of the economy, own massive sums of public debt, which dwarf their capital bases. Few institutions could withstand or survive a large reduction in their already thin-capital cushions, as might result from a public debt meltdown. Worse, it is precisely the largest, most-widely held public debts – those of the U.S. and Japan – which also seem to be the most under-priced (with excessively low yields), so a sharp rise in rates on these debts alone would have a universally negative impact, and globally.

The magnitude of potential destruction that could occur from such a plunge in the prices of such widely-held public bonds could easily dwarf the destruction witnessed in 2007-2009 during the sharp plunge in the prices of securitized mortgages, because the size of the former market dwarfs the size of the latter one. Moreover, since all sovereigns today, regardless of their leverage, and regardless of what reforms they may have adopted as a result of the financial crises of 2007-2009, nonetheless still pledge, \textit{ex ante}, to subsidize or bail out banks deemed “too big to fail,” and bank depositors deemed too prone to run their banks, so if a sovereign’s bond prices plunge to such an extent that it bankrupts the financial institutions that predominantly hold them, it would likely respond by deficit-spending to a still-greater extent, would issue still more debt, in the process of buying or assuming the private debts of the financial sector in particular
and the private sector in general, as occurred in 2009-2011; that is, they would become still more indebted, risking a credit-chain-reaction and proliferating bond-price plunges.

An alternative response to such a meltdown is for sovereigns to compel healthier, surviving financial institutions to purchase insolvent ones, as was done in March 2008 when the U.S. compelled J.P Morgan to purchase Bear Stearns, or to directly nationalize failed financial institutions, historically not an unprecedented policy, and as was done in the U.S., in 2008, with the failure of the $6 trillion-asset mortgage GSEs ("government sponsored enterprises"), Fannie Mae and Freddie Mac. This is not to say any rational, normative grounds exist to justify such policies, but only to name the facts.

There is value in comprehending “the paradox of profligacy” and in discerning whether it is true or not, or instead, as is more probable, true in one some respects but not in others. Typically, a more-leveraged, less-creditworthy borrower in the private sector must pay a higher interest rate than does a less-leveraged, more creditworthy borrower (collateral aside), and this principle appears to hold true regardless of the phase of the business cycle, whether an economy is in a recession, a recovery, or expansion. Self-interested creditors want to assure themselves that riskier borrowers pay more than do the safer ones, or that the profligate pay a higher interest rate than the frugal, whether the borrower is an individual or a business, and not only because marginal borrows, thereby, will choose themselves not to borrow, or to borrow too
much, but also because the lender thereby is compensated for the risk of default, a risk which is, of course, higher for the more-leveraged less-creditworthy borrower.

For some reason, private-sector credit principles seem inapplicable to the public realm. What holds true for private debtors seems not to hold true for public creditors. If, as the classical school insists, the two types of debtors are essentially analogous, they should be paying roughly the same interest rates, adjusted for leverage and risk profile. Clearly, they are not. On the classical view, either private debtors are paying too much, public debtors are paying to little, or some mix of these supposed mis-pricings prevails.

The new classical (rational expectations) school might say the yield differential is rationally-based, while Keynesians might say it reflects the relative innocuousness (perhaps even the superior value) of a growing public debt; finally, the public choice school might say it reflects the special political advantages enjoyed (and exploited) by constitutionally-unrestrained sovereigns (whether by its taxing power, its fiat-paper money monopoly, its “exorbitant privilege,” or its “financial repression”).

As we now know, public debt theorists in the past have been keen to consult the evidence available in open-market government bond yields, as a sign of whether public leverage is safe and sustainable (or not), and whether it is “crowding out” private savings and borrowing, J.S. Mill, writing on public debt in the mid-19th century, sought an objective measure of the excessiveness (or not) of public indebtedness, and suggested the sovereign bond yield; if it was not rising alongside the rise in the quantity of public
debt, no one could credibly say the debt rise was excessive or harmful. Likewise, we have seen De Viti De Marco looking to the sovereign borrowing rate as an indicator of the potential upper limit on public leverage. “The higher the rate of interest promised by the state,” he says, “the more available [the] savings it withdraws from industry and commerce, with resulting disadvantages similar to those produced by excessive rates of extraordinary taxation,” (389), but if, in borrowing more, the state must pays only the prevailing market rate, or less, or its borrowing rate is declining, there is no burden or crowding out of private sector needs. By this measure, most contemporary sovereigns cannot be said to have over-borrowed in recent decades (see Chapter 2, Table 3).

Setting aside causal factors for a moment, the facts are clear that many decades can transpire whereby governments dramatically boost their deficit-spending and indebtedness, relative to the productive (and tax-paying) capacity of the private economy (GDP), and yet also pay no higher or even successively-lower rates of interest on their bonds. The facts are undisputable. But of theoretical relevance is the equally-intriguing fact that today’s “norm,” that public bonds generally yield less than private-sector bonds or household credit cards, has not always been the norm. More common in the 19th century were the sovereigns of even the more-advanced industrial nations paying relatively higher interest rates than private sector borrowers. In the parlance of credit markets, whereas in “modern times” there is usually a “positive yield spread” between private and public credit, in the “old days” there was a “negative yield spread.”
More research will be required on this interesting and puzzling topic, but one hypothesis worth investigating is that the difference between the fiscal-financial world of today ("positive yield spread") versus yesteryear ("negative yield spread") may be attributable to the distinct fiscal-monetary regimes that prevailed in each era.

In the 19th century, when the taxing powers and money-creating powers of most sovereigns were not as yet so extensive or so entrenched as they would become in the 20th century, public creditors perhaps looked much more like private debtors. If in the 19th century the sovereign’s revenues came mainly from tariffs and a few “sin” taxes, but not as yet from taxes on income, estates, capital gains, payrolls, property, or retail sales in general, as would become the norm in the 20th century, and if, as well, those few and light tax revenues comprised no more than 10% of GDP, the 19th century sovereign could not be expected to have such sufficient command over resources to mark it as the system’s lowest credit risk. Yet this regards the fiscal regime only. The prevailing monetary regime further and perhaps more adequately explains the 19th century phenomenon of a “negative yield spread,” in which sovereigns tended to borrow at interest rates higher than those paid by the average private sector borrower. If in the 19th century a sovereign chose to operate under the politically-independent “rules of the game” prescribed in the classical gold standard (as did 60 nations, from 1870 to 1914), it thereby chose to restrict its capacity to create money, which, in principle, is the usual monetary status of the law-abiding private borrower who is barred from counterfeiting.
Finally, of likely relevance to any complete and valid explanation of the differential in the private-public bond-yield spread, comparing the experience of the 19th and 20th centuries, is the fact that the private sector in the prior century was generally less-burdened by taxation, regulation, antitrust actions, or arbitrary adjudications of commercial, contract, patent, and bankruptcy laws. As such, private actors generally retained more autonomy and more income (tax revenues were less than 10% of GDP); thus on legal and financial grounds alike private debtors could be more creditworthy, often more so than the state, since the state was more limited (constitutionally, fiscally, monetarily) in the 19th compared to the 20th century.

Given vast growth in the size, scope, taxing power, monetary power, regulatory power, and takings power of most 20th century sovereigns, and the extent to which such powers limit, burden, enervate, or de-capitalize society’s productive elements, it may perhaps be unsurprising that most contemporary sovereign bonds yield less than private bonds or credit facilities; if in rare cases some do not yield less, it is usually because the sovereign over-burdens the private sector (upon which it ultimately relies for fiscal sustenance), by an over-aggressive exercise of its various powers, and in the process, however unwittingly, also undermines its own fiscal integrity.

Of course, this insight brings us back, full circle, to our earlier discussion of “optimization” in public finance – to such topics as the “optimal rate of taxation,” “the optimal level (or ratio) of public debt,” “the optimal inflation rate,” or combinations
therein. But here and now we need not re-visit those arguments or re-litigate that literature. Instead, we next examine the implicit manner of public debt default which is now common: the public choice to debase the money in which debts are serviced.

6.5 Implicit Default by Inflation

In the past, over-indebted governments have either explicitly defaulted on their debt (by a non-payment of contracted interest or principal, whether intentionally or not) or else have defaulted implicitly, by deliberately debasing the currency in which their public funds have been borrowed, or their public bonds have been denominated. Since 1700 a dozen or so major cases of dramatic, one-time currency defaults have occurred, as when advanced nations like Britain, the U.S. or France left the gold standard, or remained on it but only after a devaluation (with the currency’s gold content, or real value, reduced legislatively). But since the last abandonment of any currency links to gold, that is, since 1971, implicit debt default by monetary debasement occurs not by one-time acts but by perpetual inflations. The scholarly literature typically characterizes this perpetual phenomenon as “inflationary finance.”

Sovereign resort to monetary debasement to melt down the burden and value of excessive public debt was not unknown to the classical political economists, even though they wrote in a monetary context dominated by the gold standard. Reneging on that standard and on public debts, as well, by deliberate inflations, were not uncommon. As just one example of classical perceptiveness on this subtle principle of implicit
default by inflation, consider the following passage from Adam Smith’s *Wealth of Nations* (1776), where he derides a mere “pretended payment” on a public debt:

> When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment. The raising of the denomination of the coin has been the most usual expedient by which a real public bankruptcy has been disguised under the appearance of a pretended payment. . . . The honor of a state is surely very poorly provided for, when, in order to cover the disgrace of a real bankruptcy, it has recourse to a juggling trick of this kind, so easily seen though, and at the same time so extremely pernicious. . . . Both operations are unjust. But a simple augmentation is an injustice of open violence; whereas an adulteration is an injustice of treacherous fraud. (Smith 1776 [1937], 882, 883, 885)

Reinhart and Rogoff would concur with Smith’s point that “when national debts have once been accumulated to a certain degree,” they are rarely “completely paid,” which suggests default; in fact, they might say “yes – and the ‘certain degree’ Smith writes of, they calculate as a 60% Debt/GDP ratio for less-developed nations and a 90% ratio for advanced nations. But Smith, unlike Reinhardt and Rogoff, allows not only for explicit default, what he calls a “real” bankruptcy, but also an implicit or “avowed” default; and also unlike Reinhart and Rogoff, who believe the former tactic (explicit) is more likely than the latter (implicit), Smith believes the reverse, that the “usual expedient” is debt default by inflation, by a monetary debasement, by a “raising of the denomination of the coin” (a devaluation, or decline in the legally-defined gold content
of the currency), that is, by a mere “pretended payment,” which, he insists, cannot be
classed as a debt paid “fairly.” Smith believes implied defaults are unjust.

Keynes, although a critic of classical economics, nevertheless acknowledges that
a sovereign resort to inflation could melt down a portion of the value and burden of a
public debt, but instead of advising against the tactic, or declaring it unfair or unjust
morally, he generally condones it. Recall, in his General Theory (1936), Keynes’s general
animosity toward the bondholders, what he calls “the rentier class.” He believes they are
unproductive, idle, and general undeserving of their interest income; he endorses a
deliberate, official policy of depressing the interest rate they receive, to near zero if
possible – a policy adopted by major central banks in the developed world since 2008 –
to effectuate what he calls “the euthanasia of the rentier class.” (Keynes 1936, 376)

On inflation as an implicit form of debt default, Keynes is aware of the tactic, but
unlike Smith, does not object to it, either on positive or normative grounds. A sovereign
that debases its money and thereby diminishes a portion of the real value of its public
debt, does not, Keynes insists, engage in a breach of trust or contract; the sovereign in
this case is merely “moderating the claims of the rentier” (bondholder), and it is justified
in doing so as long as believes its debts have met what he calls “an insupportable level,”
which he defines as “an excessive portion of the national income.”(Keynes 1923, 64) This
is a vague notion of a Debt/GDP ratio, although Keynes cites no critical threshold
beyond which a default invariably results. By inflating, however, the sovereign is merely
“reducing the burden of its preexisting liabilities in so far as they have been fixed in terms of money,” and Keynes knows that, with a perpetual inflation, “every step of [currency] depreciation obviously means a reduction in the real claims of the rentes-holders against their government.” Some governments will be “driven to it by necessities,” and “in order to secure the advantages” of public debt reduction, they will choose to “depreciate their currencies on purpose.” (63) In this passage Keynes discusses three ways a sovereign can default on its public debt: explicitly (by a repudiation, or deliberate non-payment), implicitly (by inflation), and by a taking (levy on rentiers):

The active and working elements in no community, ancient or modern, will consent to hand over to the rentier or bond-holding class more than a certain proportion of the fruits of their work. When the piled-up debt demands more than a tolerable proportion, relief has usually been sought in one or other of two out of the three possible methods. The first is Repudiation. But, except as the accompaniment of revolution, this method is too crude, too deliberate, and too obvious in its incidence. The victims are immediately aware and cry out too loud; so that, in the absence of Revolution, this solution may be ruled out at present, as regards internal debt, in Western Europe. The second method is Currency Depreciation, which becomes Devaluation when it is fixed and confirmed by law. In the countries of Europe lately belligerent, this expedient has been adopted already on a scale which reduces the real burden of the debt by from 50 to 100 per cent. In Germany the national debt has been by these means practically obliterated, and the bondholders have lost everything. . . . The remaining, the scientific, expedient, the Capital Levy, has never yet been tried on a large scale; and perhaps it never will be. It is the rational, the deliberate method. But it is difficult to explain, and it provokes violent prejudice by coming into conflict with the deep instincts by which the love of money protects itself. (Keynes 1923, 63-66)

The political-economy literature contains an abundance of narrative, empirics, and modeling of the phenomenon of “inflationary finance,” although some if it has
become dated, given recent experience. For centuries public finance scholars have
known that in addition to taxing and borrowing, sovereigns can secure real resources by
creating money, often ex nihilo, by printing press or electronic-bookkeeping entry. In the
past century some of the earlier, more important contributions are made by Seligman
(1921), who provides both a concise history of currency inflation and an account of its
interaction with public debt, and by Clark (1945), who writes, appropriately, in the
midst of the high inflation rates and fast-rising public debts of World War II. More
sophisticated treatments arrive later, from Bailey (1956), Friedman (1971), and
Auernheimer (1974), each of whom is generally critical of the tactic, though not of
central banking or of fiat paper money per se.

After the abandonment of the Bretton Woods gold-exchange standard in 1971, it
seems more obvious to scholars not only that inflation is accelerating but that the tactic
of inflationary finance is spreading, and thus we see such studies as by Ruebling (1975),
who, as a Federal Reserve economist, stresses that to the extent private-sector banks
participate in the money-creation (through deposit creation) they too, and not
government alone, profit by it; by Toma (1982), who finds an “inflationary bias”
embedded in the Federal Reserve System; by Barro (1983), who explores the degree to
which inflationary finance arises under systems of “discretion” (post-1971) versus
systems of “rules” (pre-1971); by Grossman and Van Huyck (1986), who portray
inflationary finance as a form of predation by government; and by Mankiw (1987), who
takes a pragmatic approach and explores how government might best secure an “optimal collection of seigniorage,” and whose theme is buttressed thereafter by Guillermo (1989), who asks how effectively inflation can melt (he says “liquidate”) the value of T-Bills, when they already efficiently incorporate inflation expectations.

Interestingly, the inflationary finance literature peaks and then slows to a virtual crawl in the 1990s (but see one of the last great performances in Neumann 1992), because budget deficits were dwindling, then surpluses built, and finally, a bizarre debate emerged (in 2000-2001) about the chances of retiring all U.S. public debt by 2012. In the 1990s it seemed that inflationary finance was a tactic of the past. In addition, interest waned due to a sustained disinflation. The U.S. inflation rate was only 2.3% p.a. in the 1960s, but then 7.1% p.a. in the 1970s (peaking at 13.5% in 1980); thereafter it dropped to 5.6% p.a. in the 1980s and to just 3.0% on the 1990s. Given the return of massive deficit-spending since 2008, the Federal Reserve’s vast expansion of its balance sheet and bank reserves, and its indefinite pledge to keep monetizing public and private debts, we should expect a renewal of the inflationary finance literature in the coming years.

As discussed earlier, in the course of our critique of Reinhart and Rogoff’s public debt analysis, an explicit default on public debt is both unnecessary and inadvisable for any sovereign that already freely issues its own money and borrows in that denomination alone. This admonition is so readily-aligned with the self-interest of the modern state (which is both constitutionally and monetarily unconstrained) that it need
not even be openly touted by policy advisors. Notably, in the large Reinhart-Rogoff
database of public debt defaults over the past two centuries, no obvious case appears
whereby a government explicitly defaults on its debt when, at the same time, it
possesses a complete and fully-discretionary power or latitude to default implicitly, by
inflation. In this setting, explicit default is precluded not only because it is more
obviously and openly an admission of a political failure, whether of fiscal prowess or
ethical integrity (versus an implicit default), but also because the explicit default simply
need not happen, given that implicit default by a deliberate inflation is altogether
possible, facile, invisible, and uncontroversial.

Of course, the fact that implicit (inflationary) defaults on public debt are easier to
execute and inflict than explicit ones, and the further fact that inflation itself is easier to
execute and inflict in the absence of strict gold standard (or some other exogenous
means of constraint on state monetary power), may cause sovereigns to borrow more
than they otherwise might. Ironically, the contemporary monetary system,
characterized by a nearly-unlimited state power to issue fiat paper money, may
simultaneously foster public indebtedness and the means for melting it down.

Thus it seems no coincidence that persistent and chronic patterns of high
indebtedness by sovereigns around the globe have been more pronounced since 1971,
after which no government in the world has committed itself to any form of the gold
standard. Some sovereigns since 1971 have tried to fix or “peg” their currencies to other
ones, notably to the relatively more stable and trusted reserve currencies (see such cases as Hong Kong, China, and Argentina), but even in such cases the sovereigns have not surrendered their power to create their own money, and of course they always reserve to themselves the right to alter or terminate a currency peg, as was done in the case of many Southeast Asian currencies in 1997-1998, and in Argentina’s abandonment of its decade-old currency board, in 2001-2002. Thus governments over the past forty years, since 1971, have been motivated, if at all, to default on their public debt only implicitly and gradually, by inflation. According to Reinhart (2012), “throughout history, debt-to-GDP ratios have been reduced in five ways: economic growth, substantive fiscal adjustment or austerity plans, explicit default or restructuring of private and/or public debt, a surprise burst in inflation, and a steady dose of financial repression that is accompanied by an equally steady dose of inflation.” The latter two methods have been those most commonly used to repudiate public debt since 1971; they are, of course, largely monetary means of default, and largely inflation-based.

Some public debt scholars contend that sovereigns are concerned that public lenders not be harmed by inflation, i.e., by implicit default. But the public choice approach is rightly skeptical of the claim; as long as sovereigns have a self-interest in defaulting, and they do if they are over-leveraged, and as long as implicit default is easier and less costly to carry off than explicit default, the former strategy will dominate the latter one. It is true that sovereigns in recent decades have introduced and sold
inflation-indexed bonds, which are designed to protect holders from the corrosive power of inflation, mainly by accreting principal annually at the official inflation rate. The most notable programs were begun by Britain in the early 1980s and by the U.S. 1997. Falcetti and Missale (2002) provide a good account of the phenomenon, while Dornbusch and Simonsen (1983) focus on the use of indexed bonds in monetary policymaking. By design, yields on inflation-indexed public bonds tend to be lower than those on so-called “nominal” (un-indexed) public bonds, because the “inflation premium” which is built into nominal bonds by astute, forward-looking investors, is effectively removed from an indexed bond.

The issuance of inflation-indexed public bonds may seem to corroborate the thesis that sovereigns seek to immunize bondholders from inflation’s harm. The evidence suggest otherwise. Significantly, sovereigns have limited their issuance of indexed bonds to a small fraction of their total debt, while stressing that their aim is to capture and monitor market-based inflation expectations (derived from the spread between higher nominal-bond yields and lower index-bond yields), not so much to immunize public creditors at large. Indeed, if the latter motive were dominant, sovereigns would issue only inflation-indexed bonds, or return to the gold standard.

Alas, a benevolent and public-spirited Treasury, keen on protecting bondholders from the ravages of inflation, is rarely to be found in contemporary states; on the contrary, the preponderance of public debt issuance is in nominal, not indexed form, so
it is clear that sovereigns wish to preserve their power to ravage public bondholders by inflation, as suggested in Bohn (1988). Inflation indexing of public bonds eliminates the sovereign’s incentive to inflate, and thereby precludes it from lightening public debt burdens. Sovereigns do not wish to eliminate this incentive; they wish to retain it, for the same reason that they unilaterally abandoned all last vestiges and currency links to the gold standard in 1971. As noted previously, implicit default by inflation is easier and less visible than explicit default – as well as uncontroversial.

Most contemporary models that seek to explain chronic deficit-spending and high public debts, with the exception of Brennan and Buchanan (1980), ignore the fact that after the abandonment of the Bretton Woods gold-exchange system in 1971, no sovereign in the world was obligated any longer to redeem its currency in gold, or even in U.S. dollars. Consequently, over-indebted governments have operated under a safety valve since 1971; they no longer need to close deficits by spending restraint or revenue raising; central banks monetize their debts, virtually without limit, and assist as well in partially but perpetually mitigating the public debt burden, over multi-year periods, by an inflation policy. Public Debt/GDP ratios are calculated on the basis of nominal GDP, so inflation by definition raises the denominator and lowers the ratio; indeed, inflation lowers the actual public debt burden, for it compels public creditors to receive payment of principal and interest in a currency of less value than they lent.
The fact that inflation is destructive and generated by sovereign-sponsored central banks with a monopoly power to issue fiat-paper-money is well-documented, and the argument is concisely-examined in Brennan and Buchanan (1981), but it also has been acknowledged by one of the system’s leading defenders and practitioners, Paul Volcker, who was an economist at the Federal Reserve Bank of New York from 1952 to 1957 (and its president from 1975 to 1979), undersecretary at the U.S. Treasury (1969 to 1974), and chairman of the Federal Reserve Board in Washington (1979 to 1987):

It is a sobering fact that the prominence of central banks in this century has coincided with a general tendency towards more inflation, not less. [I]f the overriding objective is price stability, we did better with the nineteenth-century gold standard and passive central banks, with currency boards, or even with “free banking.” The truly unique power of a central bank, after all, is the power to create money, and ultimately the power to create is the power to destroy. (cited in the Forward to Deane and Pringle, 1995)

Some economists contend that public creditors can easily and judiciously escape the dilemma of implicit default by inflation, by accurately anticipating both the magnitude and timing of a coming inflation, and in the process, shrewdly demanding the higher yields necessary to compensate themselves for the pending loss of purchasing power which inflation inflicts. Indeed, new classical economists are so confident in the forecasting and trading acumen of bondholders that they believe inflation cannot be an effective means of reducing real public debt values and burdens.

But there is good reason to doubt such extreme claims. If inflation were in fact anticipated in an accurate and timely manner, the real interest rate on Treasury bonds
(their nominal interest rate minus the inflation rate) would be steadier, historically, than either the nominal interest rate or the inflation rate; the latter two would fluctuate in tandem, but the real rate would hold fairly steady. In fact, since 1919 in the U.S. (earliest available data), while the real rate on U.S. Treasury bonds averaged 2%, it was also four times as volatile as the nominal yield and more volatile even than inflation rate.

Moreover, negative real yields (using annual averages) – which effectively means the lender pays the borrower (government) to borrow – have been recorded one-fifth of the time in the U.S. since 1919, most recently in 2012, 2011, 2008, 1980, 1979, and 1975.

This cursory review of yield data suggests public bondholders do not perfectly anticipate the inflationary implicit defaults of their clients. They are often whip-sawed by them. Some gain, some lose, but it seems reasonable to conclude that the state mostly gains by the tactic, else it would not keep doing it. Just as the state inflates to inflict hidden but lucrative taxes on currency holders, so it inflates to inflict real losses on public creditors, because it reduces the value and burden of what it owes. Public bondholders also do not possess the flawless forecasting skills required to discern the often-inscrutable and aims of policymakers; and even if, as new classical scholars insist, anticipated inflation rates cannot generate real effects, policymakers, whose aim is to secure such effects, will try to make sure they impose inflation at volatile, deceptive, and unexpected rates. (Phelps 1973, Dominguez 2009).
A brief empirical exercise can demonstrate the power now available to the unrestrained sovereign of 21st century to implicitly default on its debts, however massive and excessive they may at first appear. Again, this implies no normative endorsement of such a policy; we share Adam Smith’s view that the policy is unjust, not only the currency holders (the inflation tax) but to public bondholders, to the extent they are deprived of a fair return of (and upon) their capital.

Table 4: The Empirics of Implicit Default on Public Debt: U.S Inflation and Leverage, Past & Future

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal GDP</th>
<th>GDP Deflator</th>
<th>Real GDP</th>
<th>Gross Debt</th>
<th>NGDP Debt</th>
<th>10-Year U.S Bond Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>$269,100</td>
<td>14.5</td>
<td>1,854,200</td>
<td>$252,292</td>
<td>94%</td>
<td>2.44%</td>
</tr>
<tr>
<td>1980</td>
<td>$2,788,100</td>
<td>47.8</td>
<td>5,839,000</td>
<td>$909,050</td>
<td>33%</td>
<td>11.46%</td>
</tr>
<tr>
<td>2012</td>
<td>$15,585,600</td>
<td>115.5</td>
<td>13,548,500</td>
<td>$16,066,241</td>
<td>103%</td>
<td>1.75%</td>
</tr>
</tbody>
</table>

Multiple changes:
- a. 1948-1980: 10.4 3.3 3.1 3.6 0.3 4.7
- b. 1980-2012: 5.6 2.4 2.3 17.7 3.2 0.2

Possible futures, based on prior-period changes

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal GDP</th>
<th>GDP Deflator</th>
<th>Real GDP</th>
<th>Gross Debt</th>
<th>NGDP Debt</th>
<th>10-Year U.S Bond Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2044(a)</td>
<td>$161,479,790</td>
<td>380.1</td>
<td>42,665,134</td>
<td>$57,889,279</td>
<td>36%</td>
<td>8.22%</td>
</tr>
<tr>
<td>2044(b)</td>
<td>$87,124,180</td>
<td>279.4</td>
<td>31,437,207</td>
<td>$283,949,288</td>
<td>326%</td>
<td>0.27%</td>
</tr>
</tbody>
</table>

Note: Compounded inflation rate p.a. required to achieve: a.2004 = 3.8% and b. 2044 = 2.8%

The exercise simply draws on the facts of the past to project possible future results, and the past undeniably includes large implicit defaults by sovereigns. Table 4, in particular, provides the relevant summary data for the U.S. over the post-WWI period (since 1948), divided into two distinct periods of thirty-two years each. It includes two
scenarios of what might occur fiscally over the next thirty-two years (through 2044), based on the history.

Table 4 illustrates how the U.S. Debt/GDP ratio declined dramatically from 94% in 1948 to a mere 33% in 1980, even as the U.S. national debt increased by 3.6 times, to $909.1 billion. The leverage ratio declined because its numerator, nominal GDP, increased 10.4 times, or nearly three times faster than the debt, and nominal GDP itself grew so much faster because inflation did; between 1948 and 1980 real GDP grew 3.1 times, but the GDP deflator grew faster, by 3.3 times. In short, U.S. public leverage, or the debt burden – measured by the Debt/GDP ratio, the metric which public debt scholars now focus on, due to the work of Reinhart and Rogoff – declined significantly from 1948 to 1980, not due to fiscal conservatism, budget surpluses, or net debt redemptions, but due mainly to inflation, that is, to an implicit default on the public debt. The inflation rate was 3.8% p.a., compounded, between 1948 to 1980, and most economists in that period attributed inflation to real factors, such as “oil shocks,” not to monetary factors, such as the abandonment of the gold-exchange standard in 1971, and as a result many advised wage and price controls on private sector actors, not controls on Federal Reserve policy. This stealth debt default by the U.S. government had an assist from mainstream (Keynesian) economists. The real interest rate on the 10-year U.S. bond averaged just 1.2% from 1948 to 1980, and negative yields, whereby the U.S. government was effectively being paid to borrow, by its lenders, occurred 16% of the time.
For the more recent thirty-two year period, 1980-2012, Table 4 reveals a dramatic increase in the U.S. Debt/GDP ratio, from only 33% in 1980 to 103% at present, as U.S. federal debt increased 17.7 times, to $16.1 trillion, or nearly five times faster than the debt’s rate of increase between 1948 and 1980. The U.S. leverage ratio has increased since 1980 primarily because the rise in its numerator (gross U.S. debt) was abnormally rapid and surpassed the rise in its denominator (nominal GDP); the first increased 17.7 times, as mentioned, the last only 5.6 times (versus a rise of 10.4 times from 1948 to 1980). Nominal GDP grew less quickly from 1980 to 2012, compared to the prior thirty-two-year period, because the growth rates of real GDP and the GDP deflator were lower. Thus there was more U.S. borrowing and less U.S. inflating from 1980 to 2012, compared to 1948 to 1980. Implicit default on U.S. debt still occurred between 1980 and 2012, but not so as to prevent higher leverage. The real interest rate on the 10-year U.S. Treasury bond averaged a healthy 3.9% from 1980 to 2012, and yields were never negative, so the U.S. did not materially exploit its creditors, as it did between 1948 and 1980.

Ironically, the U.S. de-leveraged during a period when most scholars would agree that Keynesian ideas and policies were dominant – from the first edition of Samuelson’s textbook (1948) to the election of Reagan (1980). In contrast, the U.S. has re-leveraged in the three decades since 1980, a period when most observers would say Keynesianism was in disrepute, while new classical and supply-side ideas and policies were ascendant (and extended from the 1980s into the 1990s, with only minor
alterations). It is not as though supply-side policies could not reduce budget deficits (1992-1997) or even generate surpluses and debt reductions (1998-2001), to the point of fostering a serious (but now hard-to-fathom) debate, in 2000, about the implications of paying off the entire U.S. debt by 2012. But whereas federal revenues and outlays increased 1.7 times and 1.4 times, respectively, between 1992 and 2002, they rose 1.3 times and 1.8 times, respectively, between 2002 and 2012. Revenue gains far out-paced the spending rate from 1992 to 2002, but the speed of spending far-surpassed revenue gains from 2002 to 2012.

A simply, straight-forward forecast of America’s possible fiscal future can be derived from its fiscal practices since 1948, as illustrated in the lower section of Table 4. Two distinct histories and policy sets may be considered: the Keynesian policies of 1948-1980 versus the supply-side policies of 1980-2012, each comprised of thirty-two years. Counting another thirty-two years ahead, from today, brings us to the year 2044. Table 4 offers two scenarios, using 2012 data as a baseline. Scenario 2044(a) takes 2012 data and applies the multiples experienced between 1948 to 1980 and projects them forward to 2044, while scenario 2044(b) performs the same task, but uses the multiples observed between 1980 and 2012. If, over the next thirty-two years, U.S. fiscal policy were to be operated as it has been since 1980 (that is, under scenario 2044(b) in Table 4), the gross U.S. federal debt would increase nearly 18-fold, from $16.1 trillion in 2012 to $284 trillion in 2044, while inflation would compound at a rate of 2.8% p.a., and the Debt/GDP ratio
would more than triple, from 103% in 2012 to 326%, but the bond yield would be very low. Suppose, in contrast, that U.S. fiscal policy through 2044 were to be conducted like it was from 1948 to 1980, as it well might, given that we begins, as in 1948, with a high leverage ratio. This alternative is scenario 2044(b) in Table 4. The gross U.S. federal debt would increase only 3.6-fold, from $16.1 trillion currently to $57.9 trillion in 2044, while inflation would compound at a rate of 3.8% p.a., and the Debt/GDP ratio would decline from 103% at present to 36% (close to its low of 1980) but the bond yield would be very high. The Keynesian scenario is less ominous than the supply-side scenario because it counts on a higher inflation rate to melt down some of the debt. Given the Federal Reserve’s policy bias since 2008 toward large monetary expansion (however much the newly-created reserves are still hoarded), the policy of implicit default may have begun already: indeed, a former Federal Reserve economist argues that “Washington is quietly repudiating its debts.” (O’Driscoll 2008)

The lesson? Keynesians advocate both deficit-spending and high inflation, and although the first policy boosts the public debt burden, all else equal, the second mitigates it by stealth defaults. Supply-siders, on the other hand, merely tolerate deficit-spending, if it is necessary to keep tax rates low, and oppose inflation at any rate. Thus Keynesian policies foster public debt but melt them down, while supply-side policies foster public debt while insisting that they be serviced fully and fairly, so as not to punish public investors. Regardless, both camps necessarily foster chronic deficit-
spending and public debt accumulation, albeit to varying degrees, and while Keynesians seek to do so by spending more, supply-siders seek to do so by taxing less. The fiscal consequence is similar, regardless of which party controls government or which set of economists guide policy-making, for it is tax-deferred governance – by deficit-spending and debt build-ups – as unlimited democracies seem to prefer. (McKee and Roche 2012).

Shifting interpretations of public debt, and money’s role in it, since the mid-1960s, can be illustrated in the changing interpretations of Alan Greenspan, perhaps the most influential economic policymaker in the U.S. over the past half-century. He began as an economic consultant in the late 1950s, and by the mid-1970s was a top presidential advisor; from 1987 to 2006 he was chairman of the Federal Reserve. In 1966, amid the Keynesian ascendancy, he viewed deficit-spending as co-extant with a burgeoning welfare state, feared it would grow out of control, and believed only a gold standard could prevent it. (Greenspan 1966) Yet by 1971 the dollar’s last ties to gold had been severed. Amid U.S. budget surpluses in 1998-2001 and projections of an elimination of all U.S. public debt by 2012, Greenspan declared it was “highly likely” that surpluses would “remain sizable for some time (Greenspan 2001), and thus in “Life After Debt” (U.S. Government 2000) he advocated tax cuts, to forestall surpluses and future debt reductions, because he feared the Federal Reserve would lose control of monetary policy (open-market operations). In June 2011 Greenspan shifted to advising higher taxes, by “going back to the Clinton tax structure,” as “an indicator of how scared I am of this
debt problem that has emerged and its order of magnitude.” Finally, in August 2011, amid partisan wrangling about the U.S. debt ceiling, and fears of a technical default, Greenspan said “the United States can pay any debt it has because we can always print money to do that. So, there is zero probability of default.” (Greenspan 2011).

There is, of course, nothing inherently contradictory in Greenspan’s disparate observations over the years, coming as they do in distinct contexts at distinct times; in fact, they capture succinctly the transformation in prevailing attitudes about U.S. public debt over the last half-century – from a common fear, in the 1960s, that a high and rising public debt could not persist under a gold standard, to a recognition that the gold standard itself could not (and would not) persist under a high public debt, to the sober assurance that regardless of how high and fast-rising a public debt might become, it can always and easily be dissipated by fiat-paper money creation. In 1971 the U.S. explicitly defaulted not on its long-term obligations (debt) but on its short-term obligations (currency); thereafter, it could implicitly default on its debt by repeatedly inflating its currency. As we know, this was the advice of Abba Lerner, the most radical Keynesian of the 1940s; today it is not so much the ideas of a relatively-moderate Keynes (who advocated the Bretton Woods gold-exchange regime) but of Lerner that are ascendant.

6.6 Central Bank Dependence

Inflationary finance is neither the sole result of a deficit-spending government nor of a money-issuing central bank; any government, if it chooses, can borrow
exclusively from the private sector, just as its central bank could elect to issue money in exchange only for private sector assets and securities, rather than for those of government. In principle there need be no direct link or symbiotic inter-relationship between a finance ministry (or treasury) and a central bank – and if no such link exists, or only a minimal one, a central bank is deemed “independent” in the literature.

In fact, a central bank is rarely independent of its sponsoring state and the state’s fiscal demands, as exemplified in history. Goodhart (1988), for example, documents the origins of the world’s major central banks, and without exception finds that they were established not to rectify a perceived “market failure” or shortcoming of the private money and banking system, but as a means of financing a high-spending government, typically during war. In some cases central banks evolved from a previously-private bank that was nationalized after failing in the wake of being forced to lend to an already over-leveraged government. Other scholars have documented the evolution of central bank independence in particular. (Toniolo 1988)

Initially, central banks operated on the gold standard, but mainly as a mere vestige of what had been the norm and reputational requirement of the private banking system. Once states’ fiscal demands proliferated, so did their demands for debt monetization, to such an extent that fiat-money issuance came to exceed gold reserves; instead of curbing the excesses, central banks simply abandoned the gold standard, leaving holders of once-redeemable money with mere paper claims to nothing in
particular, but which legal tender laws compelled them to use. Although Goodhart (1988) includes in his history the origins of the U.S. Federal Reserve, it’s political origins and evolution are more fully (and critically) presented in Timberlake (1978, 1986, 2012).

The norm, then, is not central bank “independence,” but rather dependence; indeed there are close links and a symbiotic relationship between the deficit-spending sovereign and money-issuing central bank. The central bank underwrites and buys or sells (makes markets in) the government’s securities, in partnership with the banking system. Inflationary finance becomes the joint product of the finance ministry (or treasury department) and the central bank; it is no coincidence that every Federal Reserve Note (U.S. currency) bears the signature of the U.S. Secretary of the Treasury.

In the 1990s much scholarship was devoted to the topic of central bank independence, partly because central banks monetized more government debt than usual after the 1971 cessation of the gold-exchange, partly because some restraints were desired on the higher inflation rates that resulted from 1971, and partly in response to the break-up of the U.S.S.R., in 1991, as ex-Soviet satellites sought advice on how to disentangle state banks from the government. Cukierman (1992) offers an early and able treatment of the issue, and soon thereafter Havrilesky and Granato (1993) delve more deeply into the institutional attributes of central bank autonomy (or lack thereof) and their relation to inflation, while Pollard (1993) examines autonomy’s impact on economic performance. Posen (1993) offers a more skeptical view, suspecting that even
“independent” central banks are probably biased toward inflating, for purely political motives, and making matters worse, there is “no institutional fix for politics.”

The *economic* case for central bank independence – that it more likely fosters low-inflation prosperity and fiscal rectitude – is often trumped by the *political* case against it, in effect, by a case for central bank dependence. This means a central bank is made to serve, first and foremost, the fiscal needs of the state, and only secondarily (or not at all) the economic-financial needs of the private-sector economy. By the “fiscal needs of the state,” is meant, of course, the state’s need to borrow, first because it may be unable or unwilling to curb its expenditures, raise tax revenues, or both, and second, because it *lacks sufficient public credit*, discovering that the private sector is unwilling to voluntarily lend to it, or is willing, but not in sufficient magnitudes or on the usual, affordable terms. Since the dependent central bank is sponsored and monitored by the state, through legislative and executive acts, and since the state grants to the central bank a sole monopoly power to create money and bank reserves, the state can compel the central bank to do its bidding – that is, to serve as a lender of last (or even first) resort to the state, on favorable terms, to monetize state debts, credit funds to its account, and perhaps also purchase, at the state’s behest, the assets of troubled but favored financial institutions, industrial firms, or foreign allies.

Finally, the dependent central bank can assist the state in its financing needs by either quantitative or qualitative (price-based) measures, that is, by money creation
(“debt monetization” and “quantitative easing”) or interest-rate “targeting” (keeping short-term interest rates low or near zero, to depress government bond yields and lower the overall cost of government borrowing), or by directly purchasing extant public bonds, to artificially depress their yields and permit re-financing at lower levels. The U.S. Federal Reserve adopted each of these policies from 1942 to 1951, in support of massive war-time deficit-spending, and adopted them again starting in 2008, in support of massive peacetime deficit-spending in the U.S. Beyond the U.S., the past decade has seen ever-more indebted sovereigns become more dependent on central banks, whether for buying, underwriting, or distributing their public debt, to keep it trading close to near-zero yields. As a result, the balance sheets of the world’s major central banks have been multiplied many times over, and by now contain large and growing sums of public debt of increasingly dubious quality. Public debt theory has yet to identify the extent to which these recent, highly-expansionary central bank policies might bring a future rise in inflation (or hyperinflation), and with it, higher public bond yields.

The literature on central bank independence shows that economies perform far better when central banks are truly independent, institutionally and structurally, and not opportunistically subordinated to a sovereign’s fiscal needs; yet much of the literature also exposes the near-impossibility of achieving true independence. Taking a political economy approach, Bowles and White (1994) depict how full separation is impossible, yet say it’s inadvisable, and favor “a more autonomous but not fully
independent central bank.” Similarly, Beetsma and Bovenberg (1997) investigate the subtle interaction between public debt policy and monetary policy, in a European (albeit pre-euro) setting, and find that all works for the best, but only “in the absence of political distortions,” and such distortions intrude with the state’s borrowing needs; there is a “need to establish the credibility of discretionary monetary policies,” but this need cannot be met unless the finance ministry “restrains debt accumulation,” which, too often, it cannot. Lohmann (1998) asks whether “political business cycles” can be avoided with a scheme of central bank independence but finds that “this solution works only if central banks are not perfect agents of their political principals;” but typically they are so, which means central banks cannot be truly autonomous.

Bernhard (1998) seeks what he calls “a political explanation” for global variation in central bank independence; he says “politicians will choose an independent central bank” if disparate branches of government have disparate policy preferences; if instead preferences are more homogenous, the government will require a dependent central bank. There is no fixed criterion; autonomy is prone to political opportunism. Miller (1997) examines the theoretical difference between the “fiscal authority with access to the channels of money creation” and one that does not; the first will more likely denominate its debt in the currency issued by the dependent central bank, even though that boosts the economy’s inflation risks; moreover, “the degree of central bank independence is ultimately determined by the government and may be viewed as
another policy variable,” such that a government may only feign a commitment to autonomy, so that later it can “take away the independence of the central bank in order to inflate” away the value of its public debt. It should be obvious that in such cases there is but a sham independence. The most realistic accounts of the general inescapability of central bank dependence may be found in Tabellini (1987), in Fry (1997, 2007 – on “the fiscal abuse of central banks”), and especially in Selgin and White (1999).

At the time of America’s founding in the early 1790s, U.S. Treasury Secretary Alexander Hamilton recognized the importance of having a truly independent monetary authority, yet not a “central bank” in today’s meaning of the term. Hamilton endorsed a monetary authority (the Bank of the United States, or “BUS”) modeled on the Bank of England, which was not then a monopolist, as it is now, but an issuer a gold (and silver)-convertible currency (the pound), and otherwise left private banks alone. Similarly, Hamilton’s BUS, approved by Congress for a limited-life charter (1791 to 1811), issued a gold-convertible currency (the dollar) which competed with the economy’s other redeemable currencies. The BUS was privately-owned and managed, and legally restricted as to how much it could lend to the government. Hamilton’s Report on a National Bank (December 14, 1790) stressed the benefits of the BUS but also warned of the dangers of a politicized BUS (emphasis added):

The following are among the principal advantages of a Bank. First. The augmentation of the active or productive capital of a country. Gold and Silver . . . when deposited in Banks, to become the basis of a paper circulation . . . can acquire...an active and productive quality . . . . Secondly. Greater facility to the
Government in obtaining pecuniary aids, especially in sudden emergencies . . . 

Thirdly. The facilitating of the payment of taxes . . . Considerations of public advantage suggest a further wish, which is—that the bank could be established upon principles that would cause the profits of it to redound to the immediate benefit of the State.

This is contemplated by many who speak of a national bank, but the idea seems liable to insuperable objections. To attach full confidence to an institution of this nature, it appears to be an essential ingredient in its structure, that it shall be under a private not a public direction—under the guidance of individual interest, not of public policy; which would be supposed to be, and, in certain emergencies, under a feeble or too sanguine administration, would really be, liable to being too much influenced by public necessity. The suspicion of this would, most probably, be a canker that would continually corrode the vitals of the credit of the bank, and would be most likely to prove fatal in those situations in which the public good would require that they should be most sound and vigorous. It would, indeed, be little less than a miracle, should the credit of the bank be at the disposal of the government, if, in a long series of time, there was not experienced a calamitous abuse of it. It is true, that it would be the real interest of the government not to abuse it; its genuine policy to husband and cherish it with the most guarded circumspection, as an inestimable treasure. But what government ever uniformly consulted its true interests in opposition to the temptations of momentary exigencies? What nation was ever blessed with a constant succession of upright and wise administrators? . . .

The emitting of paper money by the authority of the government is wisely prohibited to the individual States by the National Constitution; and the spirit of that prohibition ought not to be disregarded by the Government of the United States. Though paper emissions, under a general authority, might have some advantages not applicable, and be free from some disadvantages which are applicable, to the like emissions by the States, separately, yet they are of a nature so liable to abuse—and, it may even be affirmed, so certain of being abused,—that the wisdom of the government will be shown in never trusting itself with the use of so seducing and dangerous an expedient. In times of tranquility it might have no ill consequence,—it might even perhaps be managed in a way to be productive of good; but in great and trying emergencies there is almost a moral certainty of its becoming mischievous. The stamping of paper is an operation so much easier than the laying of taxes, that a government in the practice of paper emissions would rarely fail, in any such emergency, to indulge itself too far in the employment of that resource, to avoid, as much as possible, one less auspicious to present popularity. If it should not even be carried so far as
to be rendered an absolute bubble, it would at least be likely to be extended to a
degree which would occasion an inflated and artificial state of things,
incompatible with the regular and prosperous course of the political economy.

We see that Hamilton wanted markets and citizens to have “full confidence” in
their new system of money and credit, as well as in the BUS, and so the institution had
to be “under a private not a public direction,” and motivated in its operations not by
“public policy” but instead by “the guidance of individual interest,” and profit. If this
was not the system’s design and actual working, if instead it was a politicized system,
the BUS would be forced to accommodate real and pretended fiscal “emergencies,”
caused by “a feeble or too sanguine” executive branch “too much influenced by public
necessity.” A politicized system would “corrode the vitals” of public credit. The BUS,
Hamilton warned, must not be “at the disposal of the government,” for if it were, it
would suffer a “calamitous abuse” at its hands. Hamilton makes the case not for an
“independent central bank,” which today is, in fact, a politicized (and fiscally “abused”)
institution, but for a truly independent monetary authority that was not beholden to the
state and did not undermine the safety and soundness of the private banking system.

6.7 Capital Levies, Forced Loans and Financial Repression

Public debts, we have seen, can be cancelled or reduced in the usual (and
honorable) manner, by a sovereign simply generating annual budget surpluses and
using the proceeds to redeem outstanding debt; a sovereign might also privatize
previously-nationalized assets and use the proceeds in the same manner. We have also
seen why a sovereign might default, whether explicitly and unwillingly, or by a
deliberate repudiation of its obligations, and why it might default implicitly, by a deliberate inflation, with the help of a favored, monopolistic central bank which is able to create new monies *ex nihilo*.

In addition to the above-mentioned methods of reneging on or otherwise melting down excessive public debts, there is the lesser-known, yet insidious and powerful phenomenon known as *financial repression*. It can take the form of capital levies, forced loans, or zero-interest-rate policies, which are sometimes classified as a regulatory means by which sovereigns can secure resources, albeit indirectly. The various tactics embodied in a policy of financial repression, which seeks to benefit the public debtor at the direct expense of the public creditor, are well-explained and ably-assessed in Giovannini and de Melo (1993), Alm and Buckley (1998), Reinhart and Sbrancia (2011), and Reinhart (2012). But financial repression was first identified (and criticized) by Lutz (1947, 500), who wrote that “the compulsory [public] loan is a method of taking private wealth for public purposes,” and it “cannot be condemned too severely.” Indeed, Lutz continues, “once a government has started on this slippery downward path there is the greatest difficulty in avoiding complete financial collapse.” We may also think of artificially-low (near-zero) interest rates, a policy adopted by major central banks, not merely as a specific prescription demanded by Keynes many decades ago (to instigate what he called the “euthanasia” of bondholders), but also as a form of “fiscal illusion,”
for an official policy of artificially-low interest rates disguises the full cost of public borrowing, just as public borrowing itself disguises the full cost of public spending.

The “capital levy” is a discriminatory tax aimed squarely at public bondholders; as such it is more accurately classified as a taking, or an act of legalized confiscation. It might be called a default, yet if instead of paying what it owes, the state takes from his creditor, in the form of a “capital levy,” it seems worse than a mere default (from the viewpoint of the public creditor). David Ricardo, we have seen, advised a capital levy in the early 19th century, to lessen the burden of the large British public debt incurred during the Napoleonic wars. The capital levy was also heavily-advised in the aftermath of the large public debts incurred during World War I, as in Arnold (1918), Sydney (1918), Hook (1918), Mitchell (1918), Pigou (1918), Dalton (1923). It was re-assessed more recently, in Eichengreen (1989). It seems not out of the question, given recent experience with less-orthodox fiscal schemes, that a capital levy might again be enacted.

The “forced loan” is also an act of financial repression, indeed, an old one, and yet still used today, to an ever-greater extent, as public debts build. The sovereign either induces or mandates that financial institutions (banks, endowments, pension funds, insurance companies) own and hold its bonds; all else equal, this fosters an artificial demand for public bonds, which raises their price and lowers their yield-to-maturity, such that a sovereign can obtain cheaper funding than it might otherwise secure.
Finally, financial repression occurs whenever a central bank deliberately holds down the short-term, overnight interest rate under its direct control, to very low or near-zero levels, in order to simultaneously (or with a lag) pull down government bond yields, again, as in the case of forced loans, so government can obtain financing more cheaply than it otherwise might. Recall that Keynes favored this policy because it contributed to the “euthanasia” of public bondholders. This policy, in place in Japan since the mid-1990s, and since 2008 in the U.S., Britain, and the euro-zone, also was enacted by the Federal Reserve and U.S. Treasury between 1942 and 1951, to help depress U.S. government bonds yields during the high-debt, high-inflation years during and after World War II and its aftermath (Hetzel and Leach 2001). This version of financial repression had its critics at the time (Poindexter 1944), but its more recent version was defended, four years before it was enacted in 2008, by Bernanke and Reinhart (2004), although subsequent to its enactment the policy has been criticized on the grounds that “low rates depress savers,” while “governments reap benefits.” (Rampel 2012). This is an apt description of a policy which aims indefinitely at maintaining a near-zero short-term interest rate, but it is also the aim of the policy: not to encourage saving, investment and private capital formation, but to permit a highly-leveraged government to borrow more cheaply than it otherwise might, and thus “reap benefits” at the direct expense of savers (creditors).
6.8 The Future of Public Credit and Public Credit Theory

Perhaps by recognizing how dramatic and unprecedented have been the changes in the realm of public credit and public debt in recent years, more than a few scholars are now beginning to speculate about their future direction. (Cecchetti, Mohanty and Zampolli 2010) Below we offer our own judgments and speculations on the matter.

On a technical level, it seems the future may entail something of a conflation of money and debt, due to the excesses of public debt and dependent central banks. Traditionally, under a gold standard and a smaller, more fiscally-conservative sovereign, money is a non-interest-bearing note redeemable in a real asset, while a public debt is an obligation to pay principal and interest at a reasonable and remunerative market-based interest rate, say 4-5%. Today, in sharp contrast, currency is mere fiat-paper, a note decreed by the state which is redeemable in nothing in particular, while public debt securities are gradually being transformed into cash equivalents: non-interest-bearing state pledges to pay something equally ambiguous. Thus money is becoming debt, while debt is becoming money. Yet each are being created, ex nihilo, in ever-increasing sums, by sovereigns wielding ever-increasing discretionary political power, while at the same time lacking much that resembles real financial wherewithal. Meanwhile, heretofore private financial institutions are being transformed into mere sub-departments of official treasury departments and central banks. Thus today we may be witnessing the beginnings of a long term, and perhaps at first imperceptible, co-
opting of the private-sector financial system by the public financial sector, reflecting, at
root, the necessities and prerogatives of unrestrained democracy.

By our estimation, the deeper problems of contemporary public credit and debt
lie in unlimited majority rule. It seems that prudent and just acts of fiscal rectitude
become less common the more a nation becomes an unlimited, populist democracy, the
more it condones the evisceration or elimination of constitutional restraints on
government powers, the more it rejects the rule of law, and the more it disdains the
sanctity of contract. The populace and its electorally-sensitive representatives welcome
the benefits associated with public spending, but resist the burdens that accompany
taxation; thus a majority will favor deficit-spending and a perpetual accumulation of
public debt, and usually will vote to ensure that its taxes are light and, ideally, deferred
– that is, paid by others, whether those living abroad or living in future generations.

As to the relation between democracy and public debt, Plumper and Martin
(2003, 27), building on Barro (1996), argue, and show empirically, that there exists an
optimal level of democratic participation in governing; both too little and too much
participation lead to excessive government spending and less rapid economic growth. In
short, they say, “the beneficial impact of democracy on [economic] growth holds true
only for moderate degrees of political participation.” Thus both pure (absolutist)
autocracy (see Anderson 1988) and pure (direct) democracy are sub-optimal for
prosperity and fiscal rectitude; the optimal, intermediate point is the constitutionally-
limited state wherein popular choice occurs in a circumscribed domain. In earlier work, Mancur Olson argued, similarly, that democracies are prone to rent-seeking and to a perpetual and worsening diversion of resources from long-term investment, capital formation, and the creation of wealth to the short-term redistribution and consumption of wealth. “Countries that have had democratic freedom of organization without upheaval or invasion the longest will suffer the most from growth-repressing organization and combinations.” (Olson 1982, 77) Moreover, Brennan and Buchanan (1980) argue that the democratically-elected government tends, over time, to resemble a revenue-maximizing autocracy (or the “Leviathan” model of government), which nevertheless is insufficient to cover spending, such that deficit spending and debt accumulations perpetuate, in ways the median voter theorem does not predict. Balkan and Greene (1990), in contrast, find no significant difference between the public debt loads of autocracies and those of democracies.

The future of public credit and public debt appears unfavorable, at present, especially given currently-high public debt levels, the debt burdens that now exist relative to the size of economies, the secular economic stagnation that seems to be spreading worldwide, and the high probability that demographic trends (toward societal aging), coupled with entitlement spending commitments, will led to a still-larger build-up of public debts relative to national incomes over the coming decades. Public
bondholders are likely to be the major victims, as they lose large sums even while being forced to hold more public debt.

Public debt theory will benefit by the variety of experience that will no doubt arise in the coming decades. Current public debt theory is prone to being overly-technical and too narrowly-focused, as well as overly-enamored of Keynesian presuppositions that public debt is beneficial to the economy, and the more of it, the better. Public debt theory would benefit from a broader, political economy perspective that investigates why the size and scope of government tends to expand in the first place, and in so expanding, why there is an insufficient willingness and/or ability of taxpayers to pay for the public goods they demand. Public debt is a derivative, not a primary factor in the arena of public finance; it is the form of finance required when tax revenues fall short of spending levels, and if excessive, in today’s monetary context it is prone to being melted by a sovereign’s debasement of its own money. Deeper ideological factors may be the most relevant in determining the size and scope of government, and thus, in an unlimited democracy, where majority support matters, the magnitude of deficit-spending and public debts. At root it may be that unlimited democracy, the contemporary political ideal, is also the source of fiscal profligacy.

Public debt analysts and theorists should better incorporate in their studies the profound shifts in monetary regimes that have been witnessed in the past half-century. Debt/GDP ratios must not be interpreted out of context, outside, for example, a nation’s
taxable capacity, or apart from its monetary regime. When public debts are owed, they are owed in some monetary medium, and the nature, attributes and effects of that medium must be understood, else the performance of public debts cannot be properly understood or anticipated. Above all it is crucial to realize that 1) inflation helps debtors at the expense of creditors; 2) electorally, sovereigns prefer to defer taxation and thus deficit-spend and accumulate debt; 3) sovereigns are, by now, the world’s largest debtors; and 4) sovereigns, as monopoly issuers of their own money, are the source of inflation. Taken together, these propositions imply yet a final, crucial one: sovereigns now have a strong self-interest in defaulting implicitly on their public debts, and since they possess the power, motivation, and willingness to do so, they will likely do so.
7. Conclusion

In this work we have examined predominant theories of public credit and public debt, in light of their origins and evolution, and especially in light of the recent, record expansions of public debts and public leverage to levels not seen since World War II. We began by providing important empirical context for the debate, with succinct charts and graphs of public debt data extending as far back as the early 1700s (Chapter 2). We next examined those aspects of theory, from three main schools of political-economic thought – Classical (Chapter 3), Keynesian (Chapter 4), and Public Choice (Chapter 5) – that seek to explain the evolution of public credit and debt, their political-economic effects, the nature and meaning of the sustainability of public debt burdens, and the conditions under which governments tend to monetize or repudiate their debts.

There seems no better time in recent decades, than now, to offer a comprehensive guide and examination of public debt theory and practice. The developed world over the past dozen years has seen a remarkable reversal of fortune in public debt. In 2000 major nations were recording consecutive years of budget surpluses, expecting their indefinite continuance, and discussing how much public debt might be safely reduced. By 2012 these same nations were registering consecutive years of deficits, predicting their indefinite continuance, and worrying about how much public debt could be safely increased without causing national insolvency or interminable stagnation. Major central
banks now monetize vast public debts and keep short-term interest rates near zero indefinitely. Leading sovereign debtors have lost (or are losing) their top debt ratings.

The main thesis of this dissertation has been that public debt realists present the most persuasive perspectives and theories of public credit and debt, and as such, the most compelling and plausible interpretations of the long, fascinating history of public debt, including its more recent and seemingly-unprecedented experience. Unlike the realists, public debt pessimists and optimists have presented unbalanced, thus inadequate accounts of public debt. While pessimists have exaggerated the hazards of public debt, optimists have exaggerated its benefits; in each case, no doubt, the benefits and hazards are real, albeit rarely in the magnitudes so commonly asserted. In place of bias and hyperbole, realism provides measured, contextually-rich assessments of the benefits and hazards, alike, of public credit and debt. As such, the realist approach can provide superior guideposts for valid interpretations of future public debt policies and trends.

In making the case that analytical value can be found in classifying the major political economists as “pessimists,” “optimists” or “realists” on public credit and debt, we stress that it helps clarify public debt history, and also can help those scholars who wish to participate more informatively and intelligently in the contemporary debate, which will surely expand as much as public debt levels expand in the coming decades.

Public debt pessimists, we have found, tend to deny that governments provide productive services; as such, they view taxation and public borrowing as a drain on the
private sector and a burden on future generations; pessimists claim that high and rising public leverage is unsustainable and economically harmful, even though, in the past, similar patterns have not triggered fiscal or economic ruin. Ominous enough for public debts, the pessimists also believe public bondholders are unproductive, and advise explicit default or deliberate repudiation when they believe public debts have become “excessive.” They deny that harm can result from a refusal to repay the undeserving. The pessimists’ position, to the extent it encourages a pro-default cultural attitude, could turn even the most bullish public bondholder into a raging pessimist. Public debt optimists, although sanguine about a larger economic role for the state, and about potential gains from deficit-spending, nonetheless share the pessimists’ deep prejudice against public bondholders; they too assume public bondholders are unproductive, even parasitical, and as such, advise policymakers to subject them to near-zero interest rates, to autocratic acts of financial oppression, and to default on them implicitly, by inflation.

The realists, in contrast to both the pessimists and optimists, acknowledge that government can and should provide certain productive services, primarily national defense, police protection, courts of justice, and basic infrastructure, but that deficit-spending on social insurance or redistributive schemes tend to undermine economic productivity and prosperity. Unlike their rivals, realists insist upon public debt being analyzed contextually, in ways that incorporate rational assessments of a nation’s credit capacity, productivity, and taxable capacity. Public leverage, for the realist, is neither
inevitably disastrous nor metaphysically infinite. Since realists tend to view financiers as honest and productive, they insist that sovereign debtors service and redeem their debts honestly and fully, while eschewing any resort to explicit or implicit forms of default.

Having thoroughly examined three centuries of data and theorizing on public debt, we can now identify a disturbing lack of public awareness and even scholarly knowledge of public debt history and theory, on the part of pessimists and optimists alike. If these analytical extremists knew better the actual historical data and specific doctrinal histories, the pessimists might judge themselves more pessimistic than they need be, while the optimists might find they are more optimistic than they should be.

Our study also reveals how a thinker’s preferred political ideology tends to influence his assumptions and interpretations about public debt: whereas advocates of constitutionally-limited government are typically public debt pessimists, the proponents of a more expansive, redistributive state are usually public debt optimists. It is not as though these positions cannot comfortably (or even logically) coincide; but public debt “analysis” today too often begins and ends with political ideology, with the resulting spectacle that pessimists seem continually dumbstruck that things are not deteriorating nearly as much as they had feared, while optimists seem perpetually surprised that things are not improving nearly as much as they had hoped. A realist perspective, we suggest, can go a long way toward curbing or even eliminating these twin biases.
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