

Debt and Democracy

WORKING PAPER BY CHRISTOPHER DEMUTH

Presented at the Legatum Institute

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He presented the following working paper on *Debt and Democracy* at a recent Legatum Institute dinner. DeMuth argues that debt has become a means of pleasing and placating voters while avoiding democratic accountability, and that the reinstatement of responsible management of public debt may be essential to the sustenance of democratic self-government.

In the debates surrounding today's sovereign debt problems, many politicians and pundits, including European socialists, profess that (a) government debt is a bad thing and balanced budgets should be our goal, but (b) for the time being, we urgently need to defer that goal or to move further away from it. It is very confusing to speak of a goal that we should not pursue, and of a bad thing that we should pursue instead. Perhaps it would be more productive to try to specify when debt is good and when it is bad. My analysis will describe the three virtues of debt in the private economy, then extend them to the more problematic public sphere and try to see where things have gone awry. An important theme of my remarks is that debt has become a means of pleasing and placating voters while avoiding democratic accountability, and that the leading efforts to resolve our debt problems are seeking above all to preserve this electoral project.

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The first function of debt is investment – to bridge the span of time between a plausible idea and its productive realisation. The social utility of debt must go all the way back to the discovery of the social surplus, when agriculture began to replace hunting and gathering. For humans to progress beyond a world where everyone had to kill his lunch every day, someone had to be advanced many lunches in order to try his hand at cultivating the soil. One of the earliest laws regulating debt was Deuteronomy's prohibition of charging interest on loans of victuals to one's brother.

Debt is not only the original but also the most entrepreneurial form of finance. Many of history's greatest creative geniuses, from Mozart to James Watt to Sam Walton, were big deficit spenders, chronically in debt. Not because they were profligate but because they were consumed by ideas with no immediate return. Artists and authors, if they are successful, will in time find patrons and audiences, and entrepreneurs will find shareholders and customers. But at the start, when their ambitions may be so speculative that they themselves cannot describe them with any coherence, or so revolutionary that they sound like cranks, they are usually confined to the microfinance of loans from friends and relatives. And many find it advantageous to borrow even as they prosper.

In the modern world, the provision of credit has become fantastically specialised and reticulated, and supports investment in tandem with equity and various hybrids of the two. But as societies achieve higher levels of wealth, income, and division of labour, credit markets acquire lives of their own and find a second and a third distinctive function.

The second is a consumption function – to bridge time in consumption as well as production. This includes credit cards (which also serve a transaction function) and longer-term loans for purchasing homes, vehicles, and durable goods. Here we are borrowing not for future production, but because we are confident enough of our future production to borrow against it. We are redistributing income from our future self to our present self. Love may be wasted on the young, but, in a wealthy society, material comforts need not be wasted on the old.

The third is a pre-commitment function – to demonstrate honesty, fidelity, and diligence to strangers. Some large firms eschew debt, such as Hewlett-Packard under its founders and Apple today. But most find it useful to borrow and would do so even absent the tax bias (found in most of the advanced economies) for debt over equity financing.

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Contracting to pay out a substantial sum of cash on a regular basis assures stockholders that management is doing at least a few things right, and is collecting at least some of the earnings claimed on its financial reports. Dividends also serve this purpose, but dividends, unlike interest payments, are at the discretion of management and are therefore a weaker market signal.

Each of the functions of private debt has a close analogy in the public sector. The difficulty is that, in each case, debt is not only a tool of good government but also an inducement to bad government. And, in the absence of (a) market competition and (b) the ability of political representatives to make contracts that bind the government over time, we have no neutral institutional mechanism for sorting the good from the bad.

Public Investment

A considerable part of basic, nightwatchman government consists of long-term investments that are better financed by borrowing than by taxing, in order to spread the cost of a project over the time that it yields its benefits. These include public infrastructure – roads, bridges, sewer systems, and the like – which are routinely financed by bonds at the municipal level in the US, UK, Sweden, and several other nations. But they also include prosecuting wars, defending against foreign aggression, and pursuing large national ambitions – such as the British Empire, which was built substantially on debt.

Such investments can be highly speculative and contentious. In the United States in the mid-1980s, Senator Daniel Patrick Moynihan, a firm critic of President Ronald Reagan's economic policies, said that the 1980s would be "remembered as the decade when America borrowed a trillion dollars and threw a party." In fact, it is remembered as the

decade when America borrowed a trillion dollars and terminated the Soviet empire – an excellent investment indeed. But Moynihan’s complaint illustrates the problem. At the time, very few people had confidence in Reagan’s gambit or even comprehended what he was up to. And in the meantime, the deficit-financed military build-up was helping the economy out of recession while lubricating many unrelated political choices.

An up-to-date illustration is the proposal of Prime Minister Monti that European Union restrictions on national deficits exempt infrastructure spending. Monti is an academic economist, obviously following the logic of borrowing for spending on long-lived assets. But the Germans and European Central Bank were right to give Monti’s proposal the brush, on grounds that it would open the door to a cascade of further exemptions – for spending on education, health, and other worthy purposes with arguable future benefits. Indeed the European left is already using the Monti proposal for this purpose.

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Even when it comes to durable physical assets, many government investments turn out to have very low or even negative returns. The Western development assistance programmes of the post-World War II decades were based on the notion that physical infrastructure and industrial plants were the keys to economic “take-off” for poor nations. By the mid-1980s, the economies of recipient nations such as Zimbabwe, Zaire, and Botswana had higher shares of domestic investment and industrial production than the economies of the advanced industrial nations! But the returns were extremely poor to put it mildly: the developing nation debt crisis of the late 1980s revealed that these nations could not service their debts even at near-zero interest rates. The Western nations’ more recent, domestic investments in green energy technologies are turning out to be similarly wasteful, from the Obama administration’s half-billion dollar investment in now-bankrupt Solyndra to the monstrous windmill farms that scar the English and American countrysides. No matter: as government expenditures have shifted from traditional public goods to transfer payments, the language of investment has followed. Today, absolutely everything the government undertakes, from welfare payments to agricultural subsidies, is described as an investment by its advocates.

Public Consumption

Government, too, can borrow to accelerate consumption ahead of production. This is clearly proper when the purpose is to reduce the pain and duration of temporary bad times. An example is recovery from hurricanes, earthquakes, and other natural disasters; while some recovery expenditures are infrastructure investments, others compensate individuals for lost income, employment, and housing that for one reason or another were not privately insured against. Such expenditures may be thought of

as a form of social insurance to be paid by current taxpayers who escaped the disaster. But some major catastrophes, such as the 2005 Katrina hurricane in the United States and the 2011 Tohoku earthquake and tsunami in Japan, have financial consequences not unlike those of wars. Because the nation was wealthier before the calamity, it is not unreasonable to suppose that it will become wealthier once again, and that it is prudent to borrow against that future wealth.

But the act of balancing the known present against the imagined future pulls us into treacherous waters. Original, Depression-era Keynesianism held that governments should run deficits to achieve full employment. A post-World War II cousin, counter-cyclical fiscal policy, held that governments should run deficits during economic downturns financed by surpluses during expansions. These and other Keynesian variations, which I will call “functional fiscal policy,” are all subject to numerous objections and qualifications that have filled the economics journals for seventy years now. For example, it is clear enough when a hurricane strikes, or an economic catastrophe as severe as the financial collapse of 2008, but most recessions and booms begin and end unexpectedly and are a matter of interpretation even at midpoint. That makes it next to impossible to calibrate counter-cyclical taxes and expenditures in a timely fashion.

But the technical problems pale against one gargantuan political problem. Functional fiscal policy was conceived for an era when government’s functions were few and limited and where the balanced budget was the widely accepted norm embraced by political and intellectual elites and the general public. But the new theories helped to destroy the very consensus they had assumed as a background condition.

The various versions of functional fiscal policy were sophisticated intellectual advances in their own terms. All of them, however, were grounded in the simple logic of the home mortgage: we will grow wealthier over time, so we may safely borrow against that prospect to meet current exigencies – we will “grow our way” out of our debt. That logic seemed compelling during the Depression, when the memory of the Roaring Twenties was still fresh, and during the early years of the post-war baby boom, when continued economic expansion and technological advance seemed inevitable. But it liberated government borrowing from long-term investments and responses to natural or economic emergencies. Instead, the constraints on borrowing became abstract and malleable, based on estimates of future economic growth and the effects of public debt in suppressing private savings and capital formation. And while the home mortgage involves borrowing from oneself, government deficits involve borrowing from others.

That was catnip to many practising politicians, because it opened the possibility of providing their constituents with more government services than taxes to pay for them. Whatever the future may hold, it is sure to be populated by many people – younger and future generations – who are not voters today. One way or another, they will pay most of the costs of today’s borrowing – through higher taxes or lower services to make room for interest and principal payments on the bonds, or through lost investments if the

government defaults, or through the slow-motion default of inflation. And the possibly unpleasant task of allocating the costs will fall to future politicians.

Over the course of the past fifty years, this logic of tax shifting has transformed fiscal policy in many advanced democracies to one of perpetual stimulus. Even the most renowned economists, who understood that functional fiscal policy required surpluses as well as deficits, accommodated themselves to the logic when in government. Each new budget has involved new rationalisations for more borrowing for just a little while longer, to be repaid by unknown others sometime in the future – but the actual policy has been to move current consumption ahead of current production from every new baseline. The UK government has run a budget surplus in only six of the thirty-seven years since 1975, and the US government has done so in only five of the fifty-two years since 1960. The cumulative sizes of the deficits has far exceeded those of the surpluses, and there has

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been no correlation at all of fiscal balances to economic cycles or employment levels. The US, for example, ran deficits during the expansions of the mid-1960s and mid-1980s; one might have thought that surpluses were in order, but instead the good economic performance was offered as evidence that deficit stimulus was working well and, increasingly, that “deficits don’t matter.”

During this same period, the advanced economies were becoming much more democratic. The spirit of democratic individualism, empowered by advances in communications and education, swept away many traditional hierarchies and elites in private society, politics, and government. Our politics became more populist and our government more open to the unmediated pressures of well-organised interest groups. As a result, the composition of government spending shifted from the provision of public goods, such as defence, public safety, and physical infrastructure, to the provision of transfer payments to groups that, for one reason or another, could stake an effective claim to public resources – the elderly, the infirm, the poor, farmers, students, teachers, other public employees, homebuyers, exporters, scientists, and many more. But transfer payments, to a greater degree than public goods, result in spending on consumption, so government was increasingly devoted to current consumption rather than future investment.

I have been painting with a broad brush, so let me introduce a concrete example, the expansion of the US Medicare programme to cover prescription drugs for senior citizens. President Reagan proposed and won such an expansion in 1988. At his insistence, the programme was deficit-neutral – its expenses were funded entirely by programme fees and premiums. This proved wildly unpopular, provoking raucous street demonstrations of seniors and one actual riot, and the programme was repealed shortly after Reagan left office. George W. Bush and his political advisers learned the lesson well. The Bush prescription drug programme, enacted in 2002, was our first middle-class entitlement to

be explicitly deficit financed. Fees and premiums cover only 25 per cent of programme expenditures (which are now running north of \$60 billion annually). The Treasury borrows the other 75 per cent, year in and year out. The programme is very popular.

Growing transfer programmes financed by increasing public debt has proven to be a powerful combination. It has undermined democratic accountability, making our political representatives at once more beholden to interest groups and less responsible for making judgements for the public at large on competing claims for public resources. As compared to taxpayer-financed government, it has generated a larger public sector and lower private saving and investment and therefore slower economic growth, and has raised deep questions concerning intergenerational equity. It is possible, or course, that dramatic, unforeseeable developments in technology and economic growth will reduce these problems to manageable levels. But public debt is in the range of 100 per cent of GDP in many of our nations, and everything we know about peacetime debt at these levels points to extended periods of low economic growth and high risks of sovereign default or radical, wrenching fiscal consolidations. Greece is already there. In the US, accrual rather than cash accounting puts our debt at at least five times GDP, and generational accounting suggests that future generations will be paying nearly all of their lifetime incomes in taxes, which obviously will never happen. Calculations such as these illustrate the real harm of financing current consumption with ever-increasing public debt: it accustoms substantial segments of our populations to levels of government benefits that cannot be sustained and are certain, sooner or later, to be badly disappointed, leading to highly painful personal adjustments and likely political instability.

Looking at the current European sovereign debt crisis in this way suggests answers to two hotly-debated political questions.

The Debt-Financed Welfare State

First, it is said by many on the right that the debt crisis signals the end of the welfare state, and by many on the left that this is ideological opportunism – just look at Sweden, they say, where the welfare state is alive and well and government debt is low. But what the crisis actually suggests is that the debt-financed welfare state is coming to an end. In Sweden, balanced budgets have been taken seriously over the years and certainly in recent years; its large welfare state is financed by high current taxes, its public debt is relatively low, and the public is generally happy with that arrangement along a standard liberal-conservative spectrum of opinion. The future of the welfare state depends on the ability of larger, more heterogeneous democracies to follow Sweden's example. That will not necessarily mean a convergence to the size and scope of the Swedish state: in many nations (certainly in the US), a government financed largely by current taxes would be smaller than the current one.

Second, it is said by many, especially on the left and in the media, that the “austerity” policies that Germany, the ECB, and the IMF are forcing on Greece, Spain, Italy, and other highly indebted nations are perverse and destructive and need to be replaced by more stimulative policies to rekindle growth. These criticisms typically assume that there is an identity between austerity in government finance and austerity in the private economy, which is plainly not the case. For example, public spending in Greece and Spain has actually not gone down much, in part because their unemployment compensation programmes are extraordinarily generous and are running higher and higher – thereby contributing significantly to their horrendous unemployment rates, which are offered as prime examples of austerity. In any event, what “austerity” really means in today’s debates is that the very heavily indebted nations should be lent even more to support consumption during the current hard recession. But that is simply no longer an option for

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Greece, and it will not be for much longer for several other nations. When one says that debt financing of current consumption is unsustainable, what one means is that, at some point, the financing is going to run out. Greece has arrived at that point. Its only options are (a) a crushing immediate adjustment to its newly diminished circumstances or (b) a slower, less painful adjustment through exiting the eurozone and rapidly inflating its own currency.

Public Pre-Commitment

In the public sphere, pre-commitment-through-debt takes two forms – establishing political authority and establishing political accountability. The authority function is illustrated by Alexander Hamilton’s brilliant stroke, immediately after ratification of the US Constitution, in assuming the states’ Revolutionary War debts in order to seal the position and power of the new federal government. The accountability function, elaborated in James Macdonald’s superb book, *A Free Nation Deep in Debt – The Financial Roots of Democracy*, is the use of domestic debt to reinforce democracy by uniting the interests of the citizen and creditor on the one hand, and the political official and borrower on the other. Governments that enjoyed the allegiance of their citizens, and could borrow from them in times of emergency, acquired a great financial advantage over monarchies that had to pile up gold in anticipation of emergencies; thereafter, governments indebted to their own citizens acquired strong incentives for honesty and sobriety in managing their revenues and expenditures.

But there are problems with both functions. The authority function is ambiguous, because government authority can be used well or poorly, for good or ill. The European sovereign debt crisis has evolved into an effort to use debt assumption as a device for

establishing stronger pan-European government. But the form of authority is exceedingly unpromising. Hamilton nationalised outstanding debts incurred to win nationhood, while leaving states to their own fiscal devices for the future. In contrast, the European scheme is to Europeanise the ongoing operating debts of nations that cannot pay the debts themselves, in exchange for political/administrative controls over their fiscal policies. The effect is to replace the relatively impersonal discipline of credit markets with the decidedly personal discipline of foreign political officials. The unfolding tragedy is one of misconceived authority. The idea of European unity exerts a powerful grip on the minds of Northern European political leaders and elites; that idea is being gravely damaged by the very measures they imagine will strengthen it.

Since the recent French and Greek elections, the opponents of austerity are clearly betting that, in order to preserve the current eurozone, Germans and other northerners will relax their conditions on support for the Mediterranean nations, and the ECB will begin to pursue looser monetary policies. That – culmination of the fiscal union strategy based on a new north-south compromise – is clearly a possibility. But we simply have no

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experience with a fiscal union involving the magnitude of continuing financial transfers from stronger to weaker states that the resulting federation would require (the long-established transfers from Canada's national government to its maritime provinces don't come close).

Finally, the accountability function has lost its force in our age of global financial markets and redistributive politics. When a government's debt is held by foreigners as well as its own electorate, the alignment of political and economic interests becomes attenuated; today nearly half of the US government's publicly held debt, and similarly large shares of debt in many other advanced democracies, is foreign-held. For a large number of voters in our nations who are creditors of their own governments (either directly or through pension and retirement funds), the benefits of government redistribution from future generations to themselves swamps the default risk on their holdings. Routine deficit financing of current consumption now undermines rather than fortifies political accountability and spending discipline. Bond markets do provide some independent discipline; but when the markets begin to bite, there is a strong tendency for political authorities to step in to defer the day of reckoning – through devices with harmful consequences of their own, including making the day of reckoning worse when it does arrive.

The circumstances described here are deeply entrenched in political practice and in popular understanding and expectations. The risks they present are not only economic but political: the reinstatement of responsible management of public debt may be essential to the sustenance of democratic self government. When opportunities arise for

constructive political leadership, the events of recent years provide many lessons for reform. One lesson, for example, is to contain sovereign debt crises at the source – imagine how much better off everyone would be had Greece been permitted to default on its debt two or three years ago, which was widely regarded as unthinkable at the time. But the overarching task, which cannot begin too soon, is to develop a new public rhetoric of redistribution – teaching that, although government borrowing is appropriate for certain purposes, the routine redistribution of wealth from future generations to ourselves is profoundly undemocratic and corrupting.

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