

BUDGET DEFICITS & PUBLIC DEBT

LESSONS FOR ECONOMIES IN TRANSITION

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1.1 Abstract

Are budget deficits bad for an economy? This question has perplexed economists for centuries. Historically, three schools of thought have emerged on this matter. One school takes the position that deficits have adverse influence on inflation, interest rates and private investment. As yearly borrowings to finance budget deficits accumulate into the stock of national debt, interest payments on such debt increase the burden of taxation and have inequitable distributional consequences. Second, suggest that deficits can be employed to support economic activity and employment. Finally, there is a third school, which considers that the (deficit and) public debt has little overall impact on the economy. This paper critically evaluates these competing paradigms considering the implications for economies in transition and developing nations. In particular, it is argued that the shift in budgetary norms from a year on year balancing to perpetual deficits is a relatively recent phenomenon especially, in the Anglo Saxon countries. This shift has been visibly accompanied by a substantial increase in the size of the public sector in these countries necessitating higher taxes and attendant distortion in incentives. Economies in transition would be wiser and healthier if they could avoid such mistakes by optimising the role of government, and facilitating markets and the voluntary sector. To this end, some general policy advice is also proffered.

1.1 Introduction

Governments follow a budgetary process to make fundamental decisions about raising and allocating money for their activities. Once a year, the government presents a budget that measures its annual cash flow in the form of receipts in tax and non-tax revenue, and expenditure. While outlays are by and large fixed, revenues are uncertain and depend on a number of factors including the performance of the economy. As a result, policy makers determine a planned excess of revenues over expenditure or vice versa and economic conditions settle the actual outcome as the fiscal year progresses. The budget is balanced when government spending equals government receipts, in surplus when receipts surpass

outlays, and in deficit when outlays exceed receipts. When in deficit, governments can use multiple modes to finance their activities: levy taxes, print money, sell public assets or borrow.

In the recent history of most industrialised countries, it has been quite common that a government's outlays exceed its revenues. If borrowing is used to finance such deficit, it creates 'public' debt. Having once been created, debt requires servicing through interest payments and refinancing unless retired. Public debt is distinct from 'private' debt since the latter refers to the borrowing of consumers and businesses operating in the non-governmental (private) sector. The gross public debt of a country is the accumulation of the amounts borrowed by national governments to finance annual budget deficits. As shown in the Table I, below, public debt grows over time if budget deficits persist.

Table I: The public debt in various European countries (percentage of GDP)

	1981	1985	1990	1995
Belgium	93.2	123.1	130.9	133.7
France	22.2	31.0	35.4	52.8
Germany	35.4	41.7	43.8	58.1
Italy	59.9	82.4	98.0	124.9
Netherlands	50.9	71.5	78.8	79.7
UK	54.5	53.8	35.3	54.1
Spain	21.4	43.7	45.1	65.7

Source: Acocella (1998, p.345)

As Noll (2004) illustrates, apart from the public debt, governments also pledge guarantees to sponsor some public sector enterprises that may in turn issue debt for their own use. These obligations added to the public debt, aggregate into 'federal debt,' as per the terminology employed in the US.

The public debt may be owed to nationals (internal debt) or foreigners (external debt). In the case of internal debt, no claim against the productive resources of a nation, or the income and output that these resources generate arises from outside the political jurisdiction of a country. The sovereign has borrowed from and owes only to the units – government agencies, financial institutions, businesses, and individuals – within the nation. In contrast, external debt gives foreigners a claim on the wealth and productive resources of a nation. These distinctions assume importance while examining the economic impact of financing budget deficits (through various modes), a topic to which we turn below. Adopting roughly the approach of economic history, we begin our study with an examination of the Mercantilist and Classical thought on this issue.

1.2 The mercantilist and the classical thought

In the Western tradition, mercantilist and classical economic thought is considered as the reference point for examining debates on the economic impact of budget deficits and public debt. The core ideas presented then have continued to set the agenda for research to-date. And although the contemporary formulations of this problem are theoretically far more succinct, this has not helped to narrow down differences among extreme positions on this issue.

Stipulated against the backdrop of feudalism and an intense rivalry and warfare among the nations in Europe, mercantilist thought took public borrowing, by and large favourably. They dismissed the proposition that public debt imposed on the sovereign limitations analogous to private debt by arguing that since it was owed by one part of the community to another, it was akin to the right hand owing something to the left. Some went even further to suggest that public debt augmented the riches of a country and was a mine of gold. Others did not extend this exuberance to foreign (external) debt and considered it similar in essence to private debt. As regards to the burden of public debt, it was thought that it occurred at the time of debt creation when a government acquired command on real resources. But there was little sympathy for the suggestion that such burden was shifted to posterity (O'Brien, 1975, p.259; Buchanan, 1958, p.17).

The change of hearts on the question of public debt occurred gradually beginning with David Hume (1711-76 CE) who emphasised that public debt was analogous to the debt of a private household and could likewise open ways to many ills. Among these were: (a) rise in the power of the rentier (i.e. interest-earning) class which would inhibit its own taxation; (b), rise in taxation to a harmful level (presumably owing to additional requirements for taxation to service the debt); (c), by virtue of points a and b above, there was this potential that community in general would be sacrificed to the interests of the rentier class, and (d), increased risk of bankruptcy anticipated in the light of the European experience with public debt. He concluded that 'either the nation must destroy public credit, or public credit will destroy the nation' (O'Brien, 1975).

Three possible forms of collapse were predicted: 'natural death' of the debt i.e., its repudiation; 'violent death,' when the debt was serviced at the cost of neglecting vital functions of the state; and death at the hands 'of the doctor,' when an attempt was made to put

a levy on capital to service the debt. Notwithstanding such a violent shock and the invariable misuse of debt, he thought that, 'so great dupes are the generality of mankind that ... it would not probably be long ere credit would again revive in as flourishing a condition as before.' This is because, 'Mankind are, in all ages, caught by the same baits: The same tricks, played over and over again, still trepan them' (Spiegel, 1971, p.212).

Pursuing a slightly different analytical route, Adam Smith (1723-90 CE) saw in his *Wealth of Nations* published in 1776 that the government could finance a given volume and composition of public purchases either through tax or public borrowing. He then went on to argue that tax financing came mainly from reduced household current consumption while internal borrowing came at the cost of savings and therefore private capital formation. The public debt was considered bad in this analysis because it transferred savings from commerce and industry to the state that lost it in profligacy and wanton wars. Implicit in this view was the notion of a kind of secondary burden of public debt in terms of less capital formation resulting in less future productive capacity. This loss was in addition to the primary burden of debt that occurred at the time of debt creation when the command of resources was diverted from the private to the public sector. But these harms were not the only ills that public debt inflicted upon a nation. The very substitution of debt for taxes meant any wars would be fought longer and harder. Quoting Smith ([1776] 1966) directly: -

Were the expense of war to be defrayed always by a revenue raised within the year, ... wars would in general be more speedily concluded, and less wantonly undertaken. The people feeling, during the continuance of the war, the complete burden of it, would soon grow weary of it, and government, in order to humour them, would not be under the necessity of carrying it on longer than it was necessary to do so. The foresight of the heavy and unavoidable burdens of war would hinder the people from wantonly calling for it when there was no real or solid interest to fight for. (*Wealth of Nations*, p.408)

Thus public debt struck at the heart of the liberal political system that Smith conceived in terms of individual liberty, wealth generation, general opulence, and international peace. Finally, as to the ultimate fate of public debt, Smith's views do not seem far off from that of David Hume. Quoting again from the *Wealth of Nations*: -

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. (p. 412)

Smith then went on to explain how this 'pretended payment' i.e. debasement of money had been a recurrent feature of the monetary system of debtor nations since antiquity.

The next major contribution to the theory of public debt came at the hands of David Ricardo (1772-1823 CE) who illustrated the interdependence of debt and taxes. He elaborated that a lump sum borrowing by the state was equivalent to the present value of a future stream of (additional) annual taxes required to service the debt (to perpetuity). He thought that if the public appreciated such equivalence, then it would fully capitalise future tax payments. Otherwise, therein lied the source of deluding the members of a nation into greater spending and lesser savings (Buiter, 1990, p.230-31). So bad was public debt in the eyes of Ricardo that he once said in a speech to the British parliament, ‘This would be the happiest country in the world, and its progress in prosperity would be beyond the power of imagination to conceive, if we get rid of two evils – the national debt and the corn laws.’ Mr. Brougham, another member of parliament responded, ‘His hon. friend, the member for Portarlington, had argued as if he had dropped from another planet’ (Spiegel, 1971, p.311).

To summarize then, the classical economic thought considered public debt in essence, analogous to the debt of a private household: it reduced capital formation, facilitated government profligacy and international wars, and burdened future generations for interest payments. Thus it was an evil permitted only in emergencies; in general, a year-on-year balancing of public budgets was considered a virtue. This position constituted an integral part of a broader classical view that contemplated economic problem in terms of scarcity and relied on price signals generated by free markets to equalize supply and demand in factor and product markets. As a rule, supply created its own demand and the national income bought the national produce. As long as restrictive trade practices did not deter such self-adjustment, there was no problem with the levels of income and employment and little scope for economic intervention by the government.

1.3 The Keynesian revolution and functional finance

For some one hundred and fifty years, the classical political economy - envisioned by Adam Smith, formalised into a complete structure by David Ricardo and incorporated into the neoclassical synthesis by Marshall and Pigou - remained the dominant orthodox paradigm. It considered economy as a self-adjusting *laissez-faire* mechanism operating through a set of essentially free market institutions and bound by the two important albeit implicit constitutional rules viz., the gold standard and the balanced budget principle. Keynes, however, challenged this view in the midst of a depression that resulted in widespread involuntary unemployment across all advanced industrial economies in 1930s. Keynes argued

in his *General Theory* published in 1936 that the full employment equilibrium postulated in the classical and the neoclassical theories depended on the level of aggregate demand and that even with flexible wages, prices, and interest rates an economy may settle at one of the many other less than full employment equilibrium alternatives. Improvement upon this outcome required government intervention through public spending. This argument was the beginning of the end of the moral commitment to the classical rules mentioned above. Many, following in the footsteps of Keynes, turned his insights into an elaborate program of deficit-financed public expenditure. In particular, Lerner (1943, 1948) synthesised Keynesian insights with the mercantilist views on government borrowing creating a doctrine of functional finance. He argued that there was no merit in insisting on balancing of public accounts year on year. If necessary, such balancing ought to be done over an economic cycle with surpluses in good years offsetting the deficits in bad years.

The main thrust of the Keynesian argument was that government purchases in an under-employed economy added to aggregate demand at prevailing prices and interest rates with no arithmetic necessity for private households to offset (displace / crowd out) their own buying as long as public goods were not close substitutes for private goods. But how should government purchases be financed? Here, the mathematics of balanced budget implied that a tax-financed increase in government expenditure would raise aggregate income dollar-for-dollar (multiplier = 1). If, however, public expenditure was financed through deficit instead of taxes, the prospects for boost to aggregate income and employment were much higher (i.e., multiplier > 1). Alternatively, beginning with a balanced budget and keeping the public expenditure constant, a budget deficit created by a reduction in tax revenues, raised households' current disposable income boosting consumption on goods and services and hence increasing aggregate demand and national income. Based on these propositions, the government was envisaged to play an active stabilisation role in an economy. Lerner (1943) envisaged this role in the following terms: -

- A government should adjust its taxing and spending measures such that the aggregate demand is maintained at a level consistent with the full employment output of the economy (without causing inflation).
- A government should borrow money or repay debt to change the proportion in which the public holds money and bonds so as to maintain interest rates at a suitable level.
- A government should print money or destroy it to conform with policies pursued via functional finance.

Lerner's (1948) views on the burden of public debt were naturally a derivative of the above philosophy on deficit finance. Thus the classical analogy between the private and the public debt was dispensed with. In support, the mercantilist doctrine that the debt held by the citizens of the issuing state created no burden in aggregate was re-emphasised: 'We owe it to ourselves' stressed Lerner. The same rationale was used to dismiss the popular concern about the burden of debt on future generations. Quoting Lerner (1948): -

'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 or grandchildren and to nobody else. Taking them together they will no more be impoverished by making the repayments than they will be enriched by receiving them.' (p. 300)

When it came to the question of the link between public debt and increase in inequality, Lerner admitted that to the extent holders of debt (to whom interest flows) were different from the payers of additional taxes (to service the debt), public debt entailed adverse distributional consequences. But, in the words of Lerner, such redistribution was involved in every significant happening in an interrelated economy, in every invention or discovery or act of enterprise. By implication, there was little basis to ask for redress. Mindful that most would have trouble buying this indifference, Lerner then went on to suggest that taxes could be made progressive to diminish the resulting inequality. Finally, on the issue of external debt, Lerner took a U-turn: -

A nation owing money to other nations (or to the citizens of other nations) is impoverished is burdened in the same kind of way as a man who owes money to other men. ... An external loan enables an individual or a nation to get things from others without having to give anything in return, for the time being. The borrower is enabled to consume more than he is producing. And when he repays the external debt he has to consume less than he is producing.' (Lerner, 1948, p. 300)

To summarize, the Keynesian school especially its functional finance variant saw the analogy between private debt and internal public debt as invalid, emphasised that internal debt was

different from external debt, and did not believe that the creation of public debt involve any shifting of the primary real burden to future generations. At the philosophical level, it challenged the *laissez-faire* approach to economic management and laid the responsibility of creating full employment squarely in the government's lap opening up the way for government intervention in the economy: tax rates, monetary policy, budget deficits and public debt being the key pillars of such intervention.

1.4 The New Classical Position

Functional finance appeared to work well for a while. For at least twenty-five years after the World War II, there was an economic boom that dipped rather mildly only occasionally. As a result, unemployment was on the average lower than at any time in the previous some one hundred years. However, by late 1960s, unemployment and inflation rose simultaneously, challenging the certainties associated with the Phillips curve and symbolizing the failure of Keynesian policies. The time was ripe for the resurgence of classical liberalism. In particular, monetarism, led by Milton Friedman (1962, 1963, 1977) rapidly asserted itself as a major pole of the opposition to Keynesianism. Diverse other liberal currents also appeared. Among these, supply-side economics focussed on offering advice for economies in difficulty and public choice applied the postulates of rational choice to political processes.

1.4.1 Monetarism and deficit finance

Two threads of the monetarist thought are of special interest to our research topic. First, there is this argument that an increase in the money supply at a rate equal to its demand at current prices is non-inflationary. It generates zero costs. In contrast, an increase in money supply at a rate greater than its demand (at current prices) is inflationary. It leaves in the hands of the public excess cash balances. The public's bid to reduce these balances restores a new supply-and-demand equilibrium wherein both current and expected prices rise in proportion to the change in the quantity of money. Monetising the deficit, therefore, inflicts an 'inflation tax' on the holders of money balances. The value of this tax equals the proportional rate of change of the high-powered nominal money stock times the real stock of money balances. It is paid by the holders of money balances to the issuers of money in the form of surrendering command over real resources (Lewis and Mizen, 2000, p.177-78). Placing the loss of

purchasing power of money owing to such inflation in a larger context, Lewis and Mizen (2000, p. 413) contend:

A 'creeping inflation' rate of 2 ½ per cent per annum (like that clocked up under Bretton Woods) implies that the domestic purchasing power of the currency will be halved every generation i.e. twenty eight years (p. 413)

It is not surprising therefore that Musgrave and Musgrave (1984, p.789) consider inflation tax among the least equitable of all taxes. The arbitrariness of inflation tax incidence only reinforces this inequitable character.

The second important contribution of monetarist thought, again led by Friedman (1968), has been an emphasis on the 'natural rate of unemployment' that an economy tends to have in a state of equilibrium. This rate depends on the 'real economic forces' at play i.e. structural characteristics of the economy such as market imperfections, institutional arrangements (unemployment-insurance schemes), trade unions and the preferences of its members etc., and it has important implications for economic management. In brief, fiscal and monetary policies aimed at reducing the unemployment rate below the natural rate are ineffective in the long run. They generate an accelerating inflation. Thus there is no trade-off between inflation and unemployment; the so-called, Phillips curve on which the Keynesians hinge their economic policy recipes is vertical in the long run; the relationship disappears because agents adapt to the inflation rate, which they notice in the economy.

1.4.2 The burden of public borrowing

The new classical analysis of public borrowing has elucidated many channels through which it can adversely influence macroeconomic variables. For instance, when governments issue domestic bonds to finance deficits, they compete with private institutions and persons to borrow money likely pushing interest rates higher.¹ High real interest rates, in turn, discourage, displace, reduce or 'crowd out' private investment (Friedman and Friedman, 1980, p.264-66). Thus in the long run budget deficits result in either reduced private investment and / or (depending on the monetary policy accompanying budget deficits and its impact on exchange rates) an increased current account deficit. Alternatively, given current account deficit reflects national dissaving, government can reduce such dissaving by

tightening fiscal policy assuming the gap between private saving and private investment remains stable over time. This link between current account deficit and budget deficit is known as the twin deficit hypothesis (Fischer and Easterly (1990)).

As we saw above, a very important related question formulated by Ricardo and contested by the functional finance theorists had been that of the burden of public debt on future generations i.e. the interdependence between public borrowing and taxes. Here, Buchanan (1958) has made a key contribution. He argues that Keynesian dismissal of private-public debt analogy owes to an illusion created by focussing only on one side of the balance sheet: in case of private debt, on the liability side and in case of the public debt, on the asset side. If both the asset and liability sides were taken together, it all boiled down to whether debt-funded investment yielded, at minimum, enough returns to service and amortise the debt. And in this respect, there was no difference between the internal and external debt, or, the public and the private debt. On the burden of public debt, Buchanan draws on Adam Smith's insight that investors in government paper do not incur any sacrifice since they purchase it voluntarily. He takes the position that this insight when transposed into the utility-choice framework means that members of say, Generation I who purchase government bonds on their own volition, move to a higher indifference curve since the purchase increases their utility compared to investing in any other available alternative. This is quite opposite to what happens to the utility of the members of Generation II who inherit the burden to service this liability by paying taxes. While purchasing of government bonds is voluntary, paying part of income in taxes to service government debt previously contracted is compulsory. Since Generation II participates neither in the decision to issue debt nor in decisions as to what projects the proceeds are applied, by all means its members incur a sacrifice in servicing such debt. They are bonded into these tax payments without consent. Naturally, their utility decreases.

As Shoup (1962) argues Buchanan's thesis leaves mercantilist and functional finance position on debt burden in an embarrassing situation. For, the argument that the choice to issue debt rather than to tax Generation I is made through political representatives, offers no escape unless we assume that Generation I has the authority to act on behalf of Generation II. This suggestion in turn leads to the question, what if among the factors that influence the utility / welfare of Generation I, is a lively interest in the welfare of Generation II? To Buchanan, this

¹ Orr, Edey and Kennedy (1995) estimate that an increase in budget deficit by 1% of GDP could raise real interest rates by around 1/6% when funded through internal debt and by approximately 1/3% when funded through external debt that worsens current account deficit.

question leaves his argument essentially intact. The only change he expects is that Generation I will purchase government bonds by cutting down on consumption rather than savings. Even assuming to the contrary would make no difference to his thesis since the welfare of a generation in his framework depends on free choice. Barro (1974), however, attempts to undermine this stance by arguing that because future generations are the children and the grandchildren of the present generation, the latter behave altruistically toward them i.e., the utility of the current generation depends not only on its own consumption but also on the consumption of future generations. This extends the consumption-savings decision making horizon for the members of Generation I practically to the infinite lives of their families (continuing in future) rather than to the finite life of their own. The extension occurs through a series of bequests that each generation leaves for their immediate successors. The implications are that if a debt funded tax cut raises income over an individual's lifetime but keeps family's permanent income unchanged, then the individual will save rather than consume the incremental amount and leave it as a bequest for his descendants. Thus government bonds enter in an individual's portfolio, construed not as 'net wealth' but together with the corresponding (fully anticipated) tax liability in future. From this perspective then, when a government runs deficits by cutting taxes and keeping spending constant, individuals will not increase their spending because their permanent family income will not have changed. Similarly, when a government increases its spending financed by deficit, individuals correspondingly reduce their spending making no effect on aggregate spending. There is no difference therefore between issuing public debt and raising taxes. And there is no burden of public debt on future generations whatsoever.

Barro's formulation, known as Barro-Ricardo or Ricardian equivalence theorem, is based on an amalgamation of permanent income hypothesis² and Ricardo's insights on the theoretical equivalence of public debt and future taxes mentioned above. Notably, Buchanan (1958, p.161-62) pre-empts and discards it. Elmendorf and Mankiw (1998), Brennan and Buchanan (1987), and Buiter (1990) also deal at length with the tenuous nature of the assumptions

² We saw above that the Keynesian theory assumes that private demand depends almost exclusively on contemporaneous income receipts. This view explained well the inter-war behaviour of private consumption in the US. However, it did not shed light on the long term behaviour of consumption-and-savings. This issue attracted theoretical attention in the post-war period. Two theories were advanced, first, the permanent income hypothesis by Friedman (1957), and second, the life-cycle hypothesis advanced by Modigliani and Brumberg (1954) and Ando and Modigliani (1963). The essence of these hypotheses is that it is not the contemporaneous increase in income that determines households' disposable income but rather average expected income over a longer term horizon (e.g., a lifetime). That is why consumption is less variable over time than income and savings. This formulation brings the focus on 'expectations' that current government financial policies generate about future real after-tax incomes. If tax reductions are viewed as temporary by private households, they have far less influence on consumption than those taken as permanent cuts.

underlying Barro's framework. The empirical evidence in favour of Ricardian equivalence is also inconclusive albeit, it has not been possible to categorically reject the hypothesis because it simultaneously rejects the impact of some forms of fiscal policy (temporary cuts in taxes financed by debt) while admitting others (such as anticipated permanent cut in government purchases). Overall, evidence from the United States suggests that tax cuts do increase aggregate demand (given accommodative monetary policy) although expectations about the permanence of such cuts play some role in determining the extent to which increased income flows into consumption (Fischer and Easterly, 1990).

In contrast to the subdued support for Ricardian equivalence theorem, Buchanan's thesis on the shifting of debt burden to future generations receives support from the occurrence of intergenerational redistribution in the basic overlapping-generations models such as that formulated by Diamond (1965). When a government (beginning with balanced budget) lowers taxes without corresponding cuts in expenditure, its inter-temporal budget constraint (see the arithmetic of budget deficits and solvency above) requires that taxes be increased in future. Such an increase, however, may fall on those who are younger or not yet living enabling the living / older to consume more at the cost of the young. This prospect raises two issues. First, the implications of present fiscal policies for future tax rates. Generational accounting, as this research program is called, although based on partial accounts and a number of simplified assumptions about the future, indicates that net life-time tax rates for future generations will be substantially higher than at present (for details, see (Auerbach, Gokhale and Kotlikoff, 1991), (Auerbach and Gokhale, 1993), and (Haveman, 1994)). At the second level, there is this question of the conditions under which public loans become feasible. In this larger context, there is an emphasis on distinguishing between loans for consumption and those for investment in capital goods, and there is an associated support for capital budgeting and / or more comprehensive public sector balance sheet (Wolfson, 1979, p.102-3; Buiter, 2001).

Mankiw (2000) argues that both the Diamond-Samuelson model of overlapping generations and the Barro-Ramsey model of infinitely-lived families contradict one or more of the following empirical findings: (a), actual consumer spending follows more closely the current incomes of households, (b), many households do not have sufficient financial means required to enable them to do inter-temporal consumption smoothing, and (c), the vast majority of aggregate US capital formation stems from intergenerational transfers. Thus bequest motive is active although for only small part of the population that owns most wealth (top 5% hold some 60% of economic and 72% of financial wealth). Mankiw argues that these findings speak for developing a third alternative - the savers-spenders model of fiscal policy - that

acknowledges the great heterogeneity in consumer behaviour that is reflected in the data. In this model, economy is populated by savers whose behaviour confirms with Barro-Ramsey model of infinite horizons (smoothing not only across one's own life but also across descendants) and spenders who live from paycheck-to-paycheck consuming their entire income in every period. This model yields the following theoretical results: -

- Temporary tax changes have large effects on the demand for goods and services.
- Government debt increases steady-state inequality in income and consumption; and
- Substantial long-run crowding-out can occur if taxes are distortionary. If, however, taxes are lump sum or levied entirely on inelastically supplied labour, then government debt need not crowd out capital in the long run.

This theory retains the scope of fiscal policy in the short run but ties up its long run effects to the nature of taxation regime. Insofar as the burden of public debt is concerned, there is no escape from the result that the distribution of income and consumption are influenced for the worse i.e., against the spenders and in favour of savers.

1.4.3 Appropriate level of deficit and public debt³

If public borrowing implies postponing taxes, this raises the question of how the problem will be dealt with in future since only a portion of future national income can be taxed to service public debt while maintaining primary public expenditure consisting of (producing, purchasing, providing of) public goods and services, and transfers to households and businesses (e.g. through income support and subsidies). To the extent the total (primary and interest) expenditure in a single year exceeds tax revenues and seigniorage, it must be met by issuing new debt. This gives us our first identity of the one period public borrowing requirement: -

$$\text{New borrowing} = \text{Primary expenditure} + \text{Interest expense} - \text{Tax} - \text{Seigniorage}$$

For simplicity, let us club seigniorage (inflation tax) together with tax. Also, let D be the outstanding stock of debt (that is all of short maturity) and i the nominal interest rate on it. Then the above equation can be re-written as: -

³ Unless mentioned otherwise, most of this section is based on Macklem (1994/95) and Fischer and Easterly (1990).

$$\text{New borrowing} = \text{Primary expenditure} + i * D - \text{Tax} \quad (1)$$

Note, however, that an increase in debt in one period has implications for government's budgetary policy in the subsequent periods. In particular, to service the debt, either government spending must reduce in the future or taxes must increase. But public expenditure cannot be reduced to zero and taxes cannot rise forever. By implication, there is a prudent limit on the level of debt in relation to the productive capacity of the economy. What is that limit?

As Buiter (2001) contends, the prudent level of the public debt-to-GNP ratio depends on many structural features of the economy, its international environment, and its history or the inherited initial conditions. Among the structural features are private saving propensity, the degree of financial development of the economy, growth rate of productivity, government's ability to expand tax base, raise tax rates and compress public spending, and demographic developments. This means that there is no one-size-fits-all figure. In fact, if history provides any guidance, in Britain, debt-to-GNP ratio reached as high as 282% in 1821 (after Napoleonic wars) and 272% after World War II. These, however, were extraordinary times. Under normal circumstances, the recent Maastricht Treaty offers a model that calls for a ceiling on deficit of 3% of GDP and on net public debt of 60% of GDP for member countries. Importantly, the debt here is not just the debt exclusive to the national government, but the combined debt of all levels of government in the nation including national, state and local authorities. Of course, given the complexity of the problem, it is possible to argue that this number is not sacrosanct but rather quite arbitrary from an economic standpoint.

Once it is realised that based on economics, there is no single prudent debt-to-GNP level equally suitable for all nations, then the focus shifts to the conditions under which a given debt-to-GNP ratio can be stabilised. This problem is rather easier to approximate. In a growing economy, stabilising debt-to-GNP would mean that the level of deficit to be financed by issuing new debt in each period should equal the existing stock of debt (D) multiplied by the rate of growth of nominal GNP (say, 'z'). This gives us our second identity: -

$$\text{New borrowing} = z * D \quad (2)$$

Combining (1) and (2) above, we get the long-run budget constraint as follows: -

$$z * D = \text{Primary Expenditure} - \text{Tax} + i * D$$

or

$$(i - z) * D = \text{Tax} - \text{Primary Expenditure} \quad (3)$$

or

$$(r - g) * D = \text{Tax} - \text{Primary Expenditure} \quad (4)^4$$

or

$$\text{Change in } d = \text{primary deficit/GNP} + (r-g) * D/\text{GNP} \quad (5)$$

where d denotes the debt-to-GNP ratio, r and g represent real interest and economic growth rates, and primary deficit equals excess of primary expenditure over tax revenue.

Equations (1), (3), (4), and (5) provide useful guidance on whether the current level of taxes and expenditure can be sustained in future with a certain upper level constraint on the debt-to-GNP ratio. In particular, the following points are worthy of note: -

- the change in the outstanding public debt is the sum of two components: borrowing to finance primary deficit and borrowing to finance nominal interest on the outstanding debt.
- if the economic growth rate exceeds real interest rate i.e. $z > i$ or $g > r$, then taxes can be lowered relative to primary expenditure or existing debt can be refinanced with more debt (without the need for raising taxes)⁵ or up to a certain level, primary deficits can be sustained, all without impairing the debt-to-GNP ratio;
- If, however, the real interest rate is greater than the rate of the real GNP growth i.e. $i > z$ or $r > g$, then taxes have to rise relative to primary expenditure. Alternatively, the debt ratio will increase even if the issuance of new debt was required only to service the outstanding debt stock. Thus primary surpluses will be required (i.e. taxes will have to rise relative to primary expenditure) to service the debt and stabilise the ratio. Otherwise, risk premia may increase and at some point it may become impossible for the government to sell more debt.

The above analysis shifts our focus to the conditions under which the level of real interest rates could remain below the rate of economic growth. On this issue, Fischer and Easterly (1990) contend: -

⁴ Note that equation 4 replace $(i-z)$ in equation 3 with $(r-g)$ since $i = r + \text{inflation}$ and $z = g + \text{inflation}$.

⁵ Borrowing to pay interest on outstanding debt is sometimes referred to as Ponzi scheme, after Charles Ponzi of Boston, USA who made a fortune in the 1920s by inventing a pyramid scheme but ultimately ended up in jail and became penniless.

There are some who believe that the real interest rate should normally be below the growth rate, and that this eventual return to normality will provide an escape from the debt crisis. But an economist's instincts, rightly, are that such a free lunch is not possible. Real interest rates can be temporarily below the growth rate and could be below the growth rate for a long time in a rapidly growing economy - this is part of the virtuous circle of growth. But market forces tend to prevent the real interest rate from remaining below the real growth rate permanently. As more debt piles up, the pressure on bond markets drives up the interest rate and growth declines. If a rapidly growing economy attempts to exploit the apparently favorable debt dynamics by borrowing excessively, the growth rate will eventually fall below the real interest rate. At the level of the world economy, the normal situation should be thought of as one in which the real interest rate exceeds the growth rate. (p. 136)

And Macklem (1994/95) states that: -

Taking a longer view, it is clear that periods in which growth has exceeded the real interest rate are the exception. ... There is ... an economic argument for the real interest rate to exceed the growth rate of real output in the long run. If the real interest rate were below the growth rate of the economy, then firms and households could borrow, pay the interest on their debt with the additions to output stemming from growth, and still have a surplus left over. In such circumstances, everyone would want to borrow, in which case the demand for loans would exceed the supply, putting upward pressure on the real interest rate. The rise in real interest rate would encourage individuals to save while discouraging borrowing, thereby balancing the demand and supply of loans. Market forces will tend to push the real interest rate above the growth rate of real GDP if households prefer current consumption to future consumption on average, since lenders will have to be compensated for deferring their consumption to the future. These considerations suggest that a prudent assumption on which to base fiscal policy is that the real interest rate will exceed the real growth rate over the long term. (p. 4 of 15)⁶

We believe the message from the above economists is very clear. There are risks that interest based financing of government activities may ultimately turn out sour, as there is real danger that interest costs in the long run may exceed the economic growth rate resulting from additional investment.

One way to contest the above suggestions has been to point out that in the US, for example, the average real cost of government borrowing (risk-free rate) has been lower than the real rate of economic growth. Elmendorf and Mankiw (1998) point to research explaining this phenomenon. In brief, the rationale advanced is that risk characteristics of government debt are different from that of economic growth. A comparison of average risk free rate directly with the growth rate therefore may at times be misleading. We believe there are additional reasons. US stands out among industrialised countries being considered as a safe haven for capital. Also, its currency is used as a reserve currency by many countries. And there are political pressures on many developing countries to maintain this status.⁷ Real rates on US Dollar therefore do not necessarily get influenced by the same set of factors that impinge upon the rates on the currencies of developing countries.

⁶ Page numbers refer to the HTML version of the article available through EBSCO Host Research Database.

⁷ Some political analysts, for example, believe that among the reasons of US attack on Iraq was its decision to switch its oil exports to European currency.

This brings us to an important related issue. There is an empirical observation that governments can borrow at less than diversified private institutions (from a general equilibrium perspective, at a rate less than the marginal productivity of capital (r)). Does this represent a genuine social saving? Wagner (1987) scrutinises this question and concludes that it all boils down to if government enterprises in which the borrowed funds are invested can surpass the economic constraints - the inherent uncertainty in investment - that apply to other private firms in an economy. Given public sector does not incorporate the same incentive structure as does the private sector (see the theory of public choice below), it is not misleading to suggest that government is a rather more costlier and riskier enterprise. Thus the perception that lower government borrowing rate represents opportunities for social gain is ruled out. Instead, the rationale for a spread between the private and public borrowing rates is found in the limited liability of the former while that of the unlimited liability of government. This unlimited liability finds realisation in covering up higher cost and riskiness through present and future taxation.

Pulling the threads together, the set of equations derived in this section provides useful insights on the long run (steady state) dynamics of public debt and its relationship with economic growth, taxes, and expenditure on the one hand and government's cost of borrowing on the other hand. Overall, we reach the conclusion that it appears doubtful that governments, through fixed interest borrowing and investment, can boost economic growth on a sustained basis. Somewhere, the limit is reached as real interest rates rise beyond the real growth rates and taxes have to rise relative to public expenditure to finance public debt.

1.4.4 Deficits, Debt and Public Choice

An important dimension of the new classical research program has been an extension in the application of the economic model of self interested rational choice to the sphere of politics. The theory of public choice, as it is called, uses the tools of microeconomics to study the behaviour of public servants and politicians engaged in government decision-making, producing recommendations for optimal institutional structure and constitutional rules (Downs (1957); Buchanan and Tullock (1962), Buchanan (1967)). Such analysis adds a unique dimension to understanding the problems of budget deficit and public debt in a democratic political institutional framework that has inherent tendencies to expand the role of government over time (see Table II below).

Table II: Government Spending, % of GDP

	1870	1913	1920	1937	1960	1980	1990	1996
Austria	-	-	14.7	15.2	35.7	48.1	48.6	51.7
Belgium	-	-	-	21.8	30.3	58.6	54.8	54.3
Canada	-	-	13.3	18.6	28.6	38.8	46.0	44.7
France	12.6	17.0	27.6	29.0	34.6	46.1	49.8	54.5
Germany	10.0	14.8	25.0	42.4	32.4	47.9	45.1	49.0
Italy	11.9	11.1	22.5	24.5	30.1	41.9	53.2	52.9
Japan	8.8	8.3	14.8	25.4	17.5	32.0	31.7	36.2
Netherlands	9.1	9.0	13.5	19.0	33.7	55.2	54.0	49.9
Norway	3.7	8.3	13.7	-	29.9	37.5	53.8	45.5
Spain	-	8.3	9.3	18.4	18.8	32.2	42.0	43.3
Sweden	5.7	6.3	8.1	10.4	31.0	60.1	59.1	64.7
Switzerland	-	2.7	4.6	6.1	17.2	32.8	33.5	37.6
Britain	9.4	12.7	26.2	30.0	32.2	43.0	39.9	41.9
US	3.9	1.8	7.0	8.6	27.0	31.8	33.3	33.3
Average	8.3	9.1	15.4	18.3*	28.5	43.3	46.1	47.1
Australia	-	-	-	-	21.2	31.6	34.7	36.6
Ireland	-	-	-	-	28.0	48.9	41.2	37.6
New Zealand	-	-	-	-	26.9	38.1	41.3	47.1
Average	-	-	-	-	25.4	39.5	39.1	40.4
Total average	8.3	9.1	15.4	20.7	27.9	42.6	44.8	45.9
Source: IMF								
*Average without Germany, Japan and Spain undergoing war or war preparations at this time								

Source: The Economist September 20th 1997 (The World Economic Survey, p. 11)

In essence, the theory of public choice views politicians as representing an electoral constituency, aligning closely with its economic interests, and working through democratic decision making process to secure these interests so that their own chances of re-election are improved. When this understanding of political behaviour is brought to bear on the public expenditure decision making process, then three asymmetries emerge. First, democracies tend to favour decisions that deliver benefits to small groups (special interest groups) whereas the costs are spread over a large number of taxpayers. The converse of this rule is that since the cost of cutting government spending falls on a small number of beneficiaries while the society as a whole benefits, it is the former who have the incentive to form pressure groups and deter cost cutting. Second, democracies tend to favour decisions entailing visible benefits and invisible costs. The former coalesces the beneficiaries while the latter neutralises the opponents. Third, there is a tendency to favour decisions involving immediate gains whose cost is paid in the distant future. Budget deficits and public debt provide opportunity for the realisation of all these tendencies. Deficits spread costs over large number of taxpayers, hide these costs from those who bear it, and create an impression of producing immediate benefits at the expense of higher consequences (rising taxes, lower private capital formation, increased

trade deficits) in the future. It is not surprising therefore that as Bennett and DiLorenzo (1984) argue, 'Debt is a politician's delight' (p.219). It provides opportunity to redistribute income from future (possibly unborn) generations to the current electorate.

1.4.5 Summary

To summarise then, the new classical view may be considered as consisting of a range of opinions as regards the nature and burden of public debt and the scope to use deficits and debt as an instrument of fiscal policy. The view most popular among policy economists is that in the backdrop of self adjusting, full employment, classical economy, deficit financing comes at a long run cost: prices may rise (inflation), savings may fall, private investment may be crowded out, imbalances in external accounts may result, and capital formation may be impaired. As regards the nature and burden of debt, it is agreed that public debt shifts the burden of public expenditure that it funds, forward in time; that future taxes cause additional distortion of incentives; that there is little conceptual difference between internal and external debt; and that the analogy between private and public debt holds good in most essential respects. In contrast to this majority view, a minority believe that individuals foresee the impact of all government fiscal policy and offset it in advance by taking measures opposite to that of the government. This means, debt and taxes as alternative means of financing government expenditure are essentially similar and have no differential impact on aggregate demand. Also, there is no burden of public debt on future generations.

1.5 Case studies in public debt

1.5.1 Developing country debt

The issue of developing country debt represents an interesting case study illustrating many of the arguments against deficit and public debt presented above. In the 1950s and 1960s, many developing countries fell to the Keynesian model of debt financed government expenditure under a somewhat different garb. It was argued that internal debt and monetary finance provided the required resources for economic development inculcating forced savings. External debt alleviated constraints on domestic resources and provided expanded opportunities for investment and faster development. These high hopes, however, never materialised. A deeper analysis suggests many reasons for this failure some anticipated well by classical economists, others by a range of analyses studied under the new classical position

mentioned above.

First, foreign loans became a tool for promoting the foreign policy objectives of donor countries. Second, right from the start, a significant amount of loans was ‘tied aid’ i.e. tied to purchasing goods only from the donor countries and forbidding shopping of least expensive or most appropriate equipment. Third, the aid favoured big capital intensive projects e.g. ports, dams, and roads at the cost of rural development. Fourth, the response of the industrialised world to the oil price hike of 1970s - tightening of monetary policy - substantially raised the interest cost of commercial loans. It also triggered a downturn in the big economies hurting exports from developing countries. Meanwhile, as manufacturing began to take off in some developing nations, pressures rose in the industrialised world for protectionism. Fifth, the demise of Bretton Woods fixed exchange rate system and high interest rates resulted in heavy depreciation of developing countries’ exchange rates impairing capacity to service loans denominated in a foreign currency. Sixth, corruption and economic mismanagement of borrowed funds particularly military expenditure by developing nations detracted them from obtaining the full benefit from loans. Seventh, given many developing countries began to compete in exporting more or less similar products, commodity prices fell. Eighth, capital flight worsened the plight of developing nations. Substantial amounts of funds ‘flew’ back to the banking system in the industrialised countries inflicting a ‘double whammy’ on the capacity of debtor nations to repay interest and principal amounts. Among the prominent owners of large amounts driven out of the boundaries of developing nations were the rank and file of the political elite of developing countries. No questions were asked as to the legitimacy of such wealth either by the financial or the political system of the developed world! Ninth, the many financial crisis that have since resulted from this poor ability of developing countries to service their debts have almost invariably ended up in these nations abdicating their economic and fiscal freedom to international institutions such as World Bank and IMF. In particular, through a coordinated effort on political, educational and training front, these institutions have successfully installed technocrats in the economic ministries of many developing countries who share much of the ideology and outlook of these organisations. As a result, while both the North and South shared in the follies and failures of the developing country debt experiment, the burden of debt has fallen exclusively on developing countries (Lairson and Skidmore, 1993).

The public choice analysis of the above positive evidence could focus on many dimensions. First, it can be argued that for the then governments of developing countries, debt proved ‘a politician’s delight’ as detailed in the previous subsection. For future generations (i.e.

presently current generations), however, it is proving a burden. The severity of this burden reflects that the earlier loans were not necessarily spent on productivity enhancing investment. Second, given the inherently risky nature of investment activity - in particular if geared to produce for foreign consumption - returns did not meet either expectations or fixed interest financing costs. Third, to the extent loans were in the form of tied aid, these were meant to boost industrialised economies and were not necessarily advanced in the first place on the basis of 'economic feasibility' from the recipient's perspective. Fourth, to the extent loans represented a reward for a particular regime to adopt a particular political stance in the cold war politics there was neither a purely economic / developmental motive of these loans nor a demand for accountability. In fact, it can be argued that these loans have already been paid back in-kind by the then regimes through adopting policies required by donors. This is especially true for the governments of those developing countries legitimised more by foreign governments than by their own people through democratic choice.

Of course, it makes economic sense that creditors build their case for the continuing validity of their claims exclusively on the first explanation above i.e. bad governance while borrowers put a greater emphasis on the second, third, and fourth points seeking relinquishing of such claims and a fresh start. Lindert (1991), for instance, sees default on sovereign debt a primarily property rights problems. If developed countries could have within their reach, sufficient developing country assets to seize, incentive for default could be mitigated. On the other hand, Versi (1998) cries for mercy in the following words: -

'Every baby born in the developing world owes \$485. What chance do future generations have of ever clearing such mountains of debt? What chance do they have of being able to live off the entire fruits of their own sweat without having to give most of it away to the perpetually extended palm of the money-lender? ... All the pleading from the developing world has fallen on deaf ears. Arguments that the debts were contracted by earlier, despotic regimes are ignored; evidence that bad advice by the Bretton Woods organisations has led to the debts is produced to no avail; proof that loans were given without due responsibility similarly fails to impact. ... There is no mercy in the heart of the men who deal with money.' (p. 7)

To some analysts, (e.g. Toussaint (1999) and Rowbotham's (2000)), the above outcomes are not surprising. History is replete with instances where in the broader international struggle for power and wealth, external public debt has been used as a convenient tool to seize fiscal and political control and create dependency in lands where an otherwise overt political control is not possible. Benjamin Friedman (1989, p.13) after all is right in saying that 'World power and influence have historically accrued to creditor countries'.

1.5.2 US public debt

The US budget deficits and public debt offer quite an intriguing case of the application of the above economic analysis and a point of contrast with the developing country debt. Despite being world's largest debtor and with an annual fiscal deficit in the region of 4% of GDP, the US appears to have escaped in recent years the severity of economic consequences mentioned in literature. A number of factors may have contributed to this outcome. First, as argued above in section 1.4.3, the burden of public debt is related not to the size of the debt *per se* but instead to the capacity of the economy to service such debt. By this token, debt-to-GDP ratio provides a better indicator, which in the case of the US lies in the vicinity of 40% comparable favourably to many industrialised countries. Second, it can be argued that structural changes in the US economy and international economic environment over the past some two decades have alleviated the economic consequences of US budget deficits and public debt. In particular, deregulation, globalisation and technological innovation have played a pivotal role. In product markets, falling trade barriers and transportation costs have increased competition enabling import of cheap manufactured goods from overseas (in particular, from China) overcoming the limitations of the domestic productive capacity that suffers due to resource diversion to the public sector via government borrowing. The threat of goods price inflation is therefore removed. Likewise, liberalisation and integration of capital markets has alleviated restrictions imposed by domestic financial markets on borrowers of international stature. Referring to the latter, Barro (2003) estimates that an increase of 1% in the US debt-to-GDP ratio would raise interest rates by approximately 0.05% only, given trillions of dollars moving around in the globe every day. Third, the US stands out as a safe haven for capital, a status not enjoyed even by some industrialised countries, let alone the developing countries. Fourth, the US currency enjoys the benefits of being a currency for international reserves making US Treasuries a natural outlet for investment for countries with large trade surpluses. Fifth, the sheer size of the US Treasury market offers liquidity, which is valued highly by investors lowering the required rate of return. Together these factors place the US in a rather unique position vis-à-vis many other borrowers. Yet, the question remains whether the US economy can consistently defy the insights derived by New Classical analysis on budget deficits and public debt mentioned above. We admit the answer to this question is not straightforward and requires further investigation. What is clear, however, is that in the long run, the economic impact of deficits and debt will depend on:

- (a) Larger trends affecting financial asset markets, growth, and inflation. Policy responses to these variables and how these in turn influence lender expectations.
- (b) US expenditure priorities and policies.
- (c) Global political environment.
- (d) Status of the US dollar as reserve currency.
- (e) Economic viability of activities / investments funded from any incremental public borrowing over and above that for rolling over the existing debt.
- (f) Mode of providing for the un-funded liability of social security and medical care (an increase in taxes or decrease in government spending each will have different consequences for GDP growth).

Notwithstanding these variables, generational accounting mentioned above continues to point toward higher lifetime tax rates for future generations in the US confirming one important aspect of economic theory on public debt, that of burden of public debt on future generations.

1.6 Lessons for economies in transition

We have seen above that the budget deficit and public debt have been a matter of serious intellectual concern and debate for centuries. However, the balance of theoretical argument and empirical evidence on this issue point to the validity of the classical and the new classical positions. Researchers have convincingly illustrated that the budget deficits have by and large adverse influence on inflation, interest rates, private investment, and current account deficit. Also, as yearly borrowings to finance budget deficits accumulate into the stock of national debt, interest payments on such debt increase the burden of taxation and have inequitable distributional consequences. And, last but not least, the very capacity to create deficits has unfavourable implications for governance and at times, for peaceful international political order.

Under well-defined exceptional circumstances, deficits nevertheless can be employed to support economic activity and employment. However, risk remains that such definitions will be stretched liberally within the modern political decision making frameworks leading to an expanding public sector and a concomitant rise in taxation initiating a rather, vicious circle of profligacy and waste.

A question arises, what can economies in transition learn from the above theoretical and empirical research and historical experience. We believe three lessons of enduring value emerge from the research mentioned above. These are first, governments ought to clearly define the circumstances under which they should be able to borrow or create deficits, second, the state ought to submit itself to a fiscal constitution that promotes austerity, and third, macro- and microeconomic reforms facilitating the role of the private and voluntary sectors ought to be the top priority of governments. These steps could lay the foundations for sustained generation of wealth and mass prosperity embedded in self respect, personal responsibility, and preservation of individual incentives. We discuss these recommendations one by one.

1.6.1 When should governments borrow or resort to deficit finance?

As mentioned above, the classical and new classical research programs are at one in emphasizing that access to public debt may lead to irresponsible executive and legislative spending decisions. Buchanan (1958) analyses this issue in depth and emphasizes that public borrowing decision in essence, is no different than that facing an individual i.e. borrow when want to transfer repayment to the future and there is a viable economic case for doing so. This conclusion keeps in sight the shortcomings of the (democratic) political decision making process mentioned above i.e. over-valuation of the present benefits and under valuation of (or applying a high discount rate to) the future benefits and costs. Since these proclivities find in the public debt instrument, a useful artefact to shift the real cost of short term or consumption expenditure to future generations, funding of such expenditure through debt is clearly ruled out. In the words of Buchanan (1958): -

‘In the “classical” model which assumes substantially full employment of economic resources, public debt issue should never be allowed to appear as an alternative method of financing public expenditures, the benefits of which are presumed to accrue, in whole or even in part, to individuals making the choices. The tax is the only appropriate financing medium for such expenditures.’ (p. 158)

Conversely, political process also disfavours tax financing of genuine long term investment opportunities the benefits of which occur in future periods. In such cases, the use of public debt is said to offer merit. However, protection against opportunistic political behaviour requires that Wicksellian tradition be revived. In the event, it is recommended that some method of debt servicing and amortisation / earmarking is specified and approved together with the decision on public expenditure that is to be funded by debt. To give an example, a call for increasing salaries for school teachers (i.e. increase in current expenditure) ought to be

met through tax increases while that for a new school building (capital expenditure) through public debt with a pre-specified tax increase schedule to service such debt approved simultaneously with expenditure decision. A real life example comes from the US where roads are partly funded by dedicated taxes on motorists (now need tolls for new roads since road demand has outstripped taxation).

Wagner (1987) examines at length the microeconomic justification and stabilisation motive for debt finance. On the former, he argues that the government's ability to borrow at a better rate than other borrowers is not a sign of its less riskiness but rather that of its ability to cover up through taxation what is in reality a greater cost and riskiness of carrying a project in the public sector. On the latter, he reminds that even if we assume (unrealistically) that policy makers have full grasp of the nature of economic fluctuations and can put together an appropriate in-time fiscal policy response to them, a program of money creation and destruction would constitute a superior alternative to that of fixed interest finance. Buchanan (1958) too finds the use of public debt in depression as inefficient. He argues that since government's purchase of resources under these circumstances does not come at a cost to the private sector, the real cost of such an operation ought to be zero. The only way for a government to entail zero cost when acquiring command on real resources is by expanding the monetary base. And that is precisely what is recommended in depressions.

All in all, the call is first, for limiting government borrowing for capital expenditure purposes only, second, subject such expenditure to either Wicksellian (1896) supra-majority constraint and / or simultaneous joint expenditure-(future) taxation scheduler approval, and third, placing constitutional limits on borrowing (see below). Some question government borrowing even for investment purposes given well-known incentive problems in the public sector. They call outright for balanced budgets. Under recession only is there a support for deficit finance but there too, not in the form of borrowing but through monetary finance.

1.6.2 Promoting fiscal discipline through constitutional rules

We mentioned above the gradual weakening of the Victorian and Puritan moral constraints against debt. In fact, the fall of the Gold Standard too played an important role in removing a check against government profligacy. Thus Greenspan (1966) reminds that gold standard served as protector of property rights and a shield against 'hidden' confiscation of wealth

(through inflationary finance of wasteful public spending). Greenspan (1981) reflects a desire to return to the gold standard but envisages difficulties albeit not to the extent insurmountable.

In the past some twenty years, a greater recognition of the political economy argument that there are inherent political tendencies to misuse budget deficits and public credit, has resulted in building a professional momentum in favour of reviving rule-based fiscal policy. Buchanan, Wagner and Burton (1978), and Niskanen (1992) provide useful guidance. Kopits and Symansky (1998) examine literature on this issue and run some simulations. They define a fiscal policy rule as a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance. The Table III below summarises some fiscal rules that can be embedded in a constitution to provide automatic restraint against the ‘Leviathan’ tendencies of governments.

Table III: Major Types of Fiscal Policy Rules

<p><i>Balanced-budget or deficit rules</i></p> <ul style="list-style-type: none">• Balance between overall revenue and expenditure (that is, prohibition on government borrowing); or limit on government deficit as a proportion of GDP.• Balance between structural (or cyclically adjusted) revenue and expenditure; or limit on structural (or cyclically adjusted) deficit as a proportion of GDP.• Balance between current revenue and current expenditure (that is, borrowing permitted only to finance capital expenditure). <p><i>Borrowing rules</i></p> <ul style="list-style-type: none">• Prohibition on government borrowing from domestic sources.• Prohibition on government borrowing from central bank; or limit on such borrowing as a proportion of past government revenue or expenditure. <p><i>Debt or reserve rules</i></p> <ul style="list-style-type: none">• Limit on stock of gross (or net) government liabilities as a proportion of GDP.• Target stock of reserves of extra budgetary contingency funds (such as social security funds) as a proportion of annual benefit payments.
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Kopits and Symansky (1998, p.2)

Naturally, there are calls for exemption from these rules in the case of emergency to avoid temptation for external aggression.

1.6.3 Facilitating markets and limiting the role of government

The above discussion brings us to the importance of rules, enforcement mechanisms, and organizations in general that facilitate and promote economic development by transmitting information, enforcing property rights and contracts, and managing competition (World Development Report, 2002). Together such infrastructure provides what may be called as the core of governance structure in a country. Iqbal and Lewis (2002) examine research in this area and highlight an agenda for domestic reforms consisting of four items: limit concentration of powers, constrain discretionary powers, strengthen institutions, and enhance and enforce monitoring and accountability. The first requires a workable and balanced separation of powers on the one hand, amongst the executive, the legislature, and the judicial arms of the government, and on the other hand, amongst central, state, and local authorities. Each level of government in turn ought to have appropriate checks and balances. As mentioned above, discretionary power of both politicians and civil servants provide opportunities for evasion and waste of public funds. In a way, a properly functioning system incorporating a separation of powers also protects against abuse of discretionary powers. The judicial system is a case in a point. Not only does it resolve disputes between private parties but also, between private and public parties. By doing so, it provides a check on public excess. The components of administrative reform program aim at bringing civil service as close as is possible to the Weberian model i.e. politically neutral, professionally competent, goal-oriented, dedicated, and functionally sound. Limiting concentration of powers and strengthening institutions contributes significantly to accountability and transparency. Nevertheless, it also requires complementary help from the deterrence as well as media side. In terms of economic analysis, given that human beings are rational agents, their criminal behaviour takes at least two factors into account: probability of detection and punishment and the penalty in case of prosecution (Becker, 1968). Therefore, both detection and enforcement priorities ought to feature in the reform agenda. Table IV summarizes the tools available to facilitate accountability.

Table IV	
Choosing the Tools for Accountability	
Ends To facilitate / enhance	Means Tools
Legitimacy of decision-makers	Constitutions; electoral systems for government and decision making bodies; bureaucratic systems of representation; Royal Prerogative; legislation; letters of appointment; formal delegation of authority; standing orders.
Moral Conduct	Societal values; concepts of social justice and public interest; professional values; training / induction programs.
Responsiveness	Public participation and consultation; debates; advisory bodies; public meetings; freedom of speech.
Openness	Parliamentary question times; public information services; freedom of information laws; public hearings; green and white papers; annual reports.
Optimal resource utilisation	Budgets; financial procedures; rules of virement; parliamentary public accounts committees; auditing; public enquiries and participation; formal planning systems.
Improving efficiency and effectiveness	Information systems; value for money audits; setting objectives and standards; program guidelines; appraisal; feedback from public.

Source: M R Hayllar modified by Turner and Hulme.

The World Development Report 2002 brings to a sharper focus the need for:

- Actualising an open, transparent and friendly environment for commerce, trade and foreign investment;
- Effective government oversight of corporate governance practices so as to promote transparency and increase public confidence in the private sector;
- Improving the prudential framework for financial institutions so as to ensure timely, accurate and reliable flow of information from financial intermediaries and prevent economic and financial crisis;
- Evolving institutions that alleviate information asymmetries, which retard access of the poor to credit markets;
- Promoting trade liberalization and removal of entry and exit barriers for firms so as to expand opportunity for participation in market, facilitate free market competition, and reduce transaction costs of doing business.

In the final analysis, the key to boosting economic growth for nations and to reducing poverty for individuals lies in following the classical advice in expanding the role of free market competition so as to engage more and more people in productive effort that is rewarded by the market. Governments can do a lot in facilitating such environment by ensuring property

rights, lowering transaction costs and promoting competition. To this end we have provided some suggestions and alluded to important research work done in this area.

1.7 Conclusion

We begin by recapping the differences between the Keynesian and the classical views. The Keynesian model allocates substantial role to government in economic stabilisation and development. To achieve this objective, deficit finance is acceptable, rather necessary in certain circumstances. But almost invariably accompanied with this strategy is financial repression and inequity - through inflation tax, protection, and redistribution across generations through debt - which makes state ownership possible notwithstanding the inefficiency of production in the public sector. In fact, the very allowance to state to engage in debasing money and borrowing aligns very poorly with the incentives for efficient spending of monies so raised. Not surprisingly, the problem of public debt (in particular sovereign debt) has at times plagued the entire global financial system and indirectly influenced economic growth for the worse. In contrast, in the classical analysis, a government is an inefficient player when it comes to taking on some of the role assumed by the market. It therefore ought to limit its role to the prior conditions necessary for an orderly operation of free markets. And that primarily means undertaking responsibility for law and order, delivering justice, and overseeing competition and level playing field. To this end, there is allowance for raising taxes. Beyond that, there is little role for government *per se* in economic development and no allowance for deficit finance.

Given overwhelming theoretical and empirical support of the classical pro-market stance by the new classical research program, an economic strategy based on it focuses at three levels. First, fiscal austerity ought to be accepted as a driving force in state financial management. Second, there is this stress on a sound constitution of fiscal responsibility circumscribing the conditions under which deficit finance and public borrowing are legitimised. It is recommended that at minimum, all current expenditure ought to be financed through taxes and at the level of each deficit financed proposal, expenditure estimates ought to accompany with schedules for servicing the liability. Third, steps ought to be taken to institute pre-conditions for expanding the role of the market, promoting business friendly environment and inviting private investment.

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