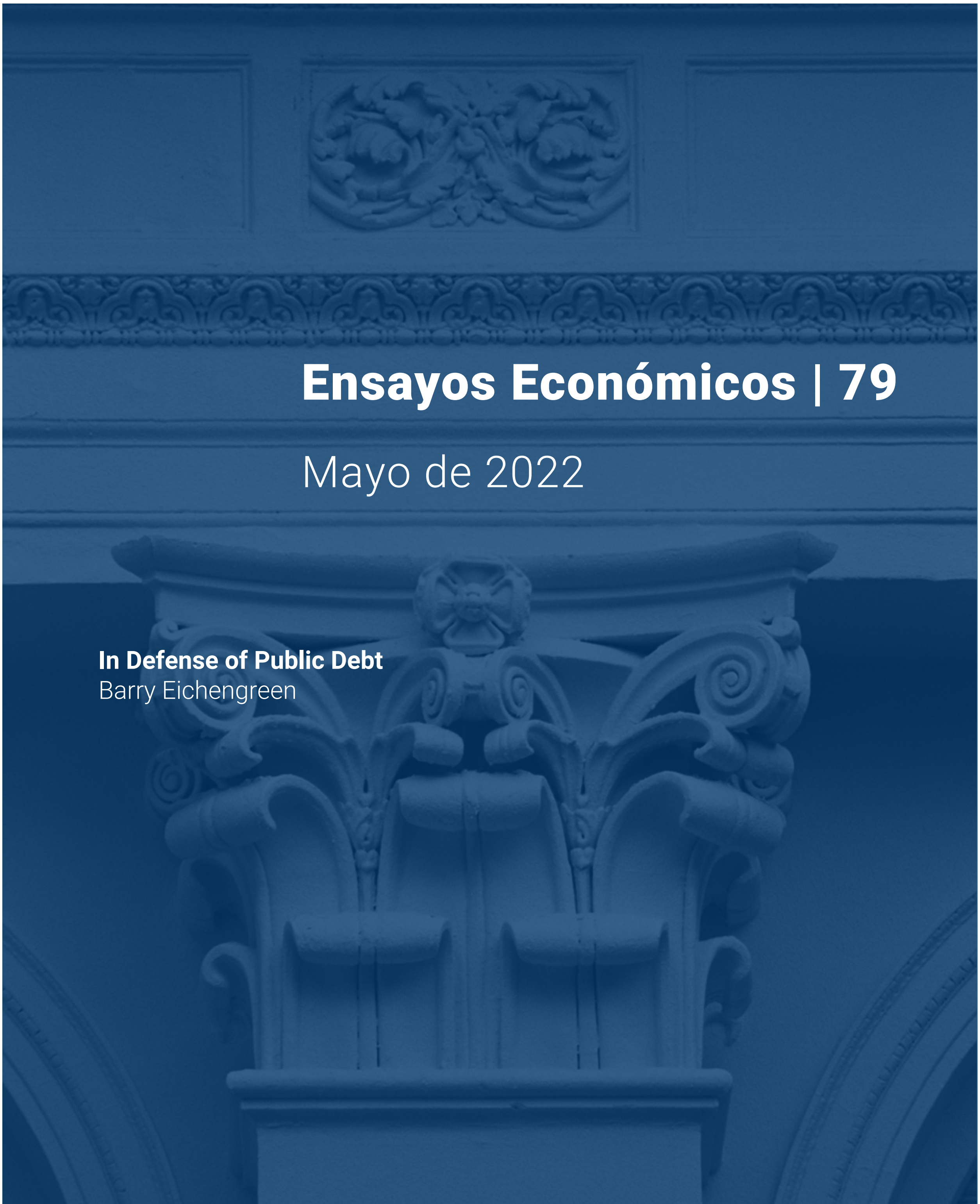

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**In Defense of Public Debt**

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# In Defense of Public Debt

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## Abstract

I offer a balanced view of the benefits and risks of public debt issuance. The role of public debt in mobilizing resources to meet national emergencies is a historical constant, most recently illustrated by the response to the COVID-19 pandemic. But this emergency response also leaves a legacy. I reflect on the prospects for debt consolidation and on how governments should meet the challenge of managing public debt now as we enter a period of higher global interest rates.

*JEL Classification*: N1, G1.

*Keywords*: economic history, public debt, sovereign debt.

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# En defensa de la deuda pública

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## Resumen

Planteo una visión equilibrada de los beneficios y riesgos de la emisión de deuda pública. El papel de la deuda pública en la movilización de recursos para hacer frente a las emergencias nacionales es una constante histórica, ilustrada recientemente por la respuesta a la pandemia del COVID-19. Pero esta respuesta de emergencia también deja un legado. Reflexiono sobre las perspectivas de la consolidación de la deuda y sobre el modo en el que los gobiernos deberían afrontar el desafío de gestionar la deuda pública ahora que entramos en un periodo de tasas de interés globales más elevadas.

*Clasificación JEL:* N1, G1.

*Palabras clave:* deuda pública, deuda soberana, historia económica.

## 1. Introduction

Recent years have witnessed a sea-change in how elected officials and their constituents view public debt. Anyone over the age of 50 will recall the 1990s, when there were widespread concerns about government profligacy and pervasive fears that debt was on an unsustainable path. These worries found their way into the Maastricht Treaty, which required European countries to limit their budget deficits to 3 per cent of GDP and bring their public debts down to 60 per cent of GDP, or at least close to that level, in order to qualify for admission to the euro area. The U.S. Congress adopted the 1990 Budget Enforcement Act, under which permissible spending rose more slowly than inflation and new outlays were subject to pay-as-you-go rules requiring either additional taxes or cuts in other programs. Worry was widespread that government spending was dangerously out of control.

This consensus that excessive spending was a problem and that fiscal consolidation was required to correct it wobbled in the face of the Global Financial Crisis. The United States adopted the $787 billion American Recovery and Reinvestment Act (or Obama Stimulus), causing federal debt to shoot up from 64 percent of GDP at the beginning of 2008 to 84 percent at the end of 2009. European countries such as Ireland, forced to recapitalize broken banking systems, experienced even larger increases in indebtedness. But once recovery dawned, and sometimes even before, governments took a quick right turn toward austerity. The fiscal events of 2008-09 were dismissed as just a temporary, if necessary, deviation from orthodoxy. As soon as the crisis passed, debts and deficits were again seen as a problem. Fiscal consolidation again became the name of the game.

## 2. Enter COVID-19

COVID-19 turned this fiscal world, along with much else, upside down. Governments are running unprecedented deficits and accumulating unprecedented debts. The U.S. federal government deficit is an extraordinary 14 per cent of GDP and would be still larger if President Joe Biden had his way. Federal government debt in the hands of the public now exceeds 100 percent of U.S. GDP. Germany has abandoned its iconic debt brake in favor of a deficit of 4.2 per cent of GDP in 2020; the European Commission forecasts that the Federal Republic's deficit will be twice again as large in 2021. Euro area wide, debt is more than 100 percent of GDP, just as in the U.S. – far above Maastricht levels. European Commission officials, traditionally the enforcers of austerity, are now, instead, cautioning governments not to raise taxes or cut public spending prematurely.

So, is this change in attitudes and practices justified? And will it last?

Extraordinary circumstances, such as those of a global pandemic, when not just livelihoods but also lives themselves are at risk, clearly justify extraordinary action. A government that does not respond to this kind of public-health emergency by mobilizing all available resources, including by issuing debt, will not long retain its legitimacy. Public debt scolds, when cautioning against deficits, reason by way of analogy between the household budget and the government budget. Just as a responsible household should balance its budget and live within its means, so too, they argue, should a responsible government. Under ordinary circumstances, perhaps. But a government that doesn't borrow in order to provide essential services during a deadly pandemic would be accused of dereliction, and rightly. Such a government, to continue with the analogy, would be like parents who refused to borrow to obtain life-saving surgery for a child.

## 3. History lessons

This pattern has recurred throughout history. States and leaders have long borrowed to meet national emergencies, first and foremost wars. Rulers have borrowed to expand their territories but also to defend the realm and survive. Borrowing to mount a sturdy national defense worked to strengthen the state, not just in the material sense of repelling invaders but also in a political sense, since a state that provided an adequate national defense was seen as legitimate in the eyes of its citizens.

It followed that Europe was the world's debt pioneer, since war was especially prevalent, for a combination of geographic and political reasons, on the European continent. After the collapse of the Carolingian Empire in 888, Europe was divided into literally hundreds of princely kingdoms, many no more than cities with modest hinterlands. Europe's geography as a landmass riven by mountain ranges and river valleys posed natural obstacles to the formation of more extensive territorial states. This division into a multitude of jurisdictions tempted rulers to seize territory and resources when they could and placed them at the mercy of their neighbors. As the eminent sociologist and historian Charles Tilly put it, war was the normal condition in Europe from the dawn of the second millennium A.D.

It is commonly asserted that prior to the 20$^{th}$ century, when indebtedness became a common condition, sovereigns accumulated debt during wars and retired it in peacetime, so that they would have a clean financial slate when the next war broke out. In practice, however, not all debt issued in wartime was retired subsequently. Levels of indebtedness rose over the centuries, as states built the economic, financial, and political infrastructure needed to service additional obligations.

## 4. Making a market

The king or sovereign was regarded as the supreme earthly power. Ironically, this unlimited power limited his ability to borrow, since there was nothing to prevent him from unilaterally reneging on his obligations. Sovereigns could borrow, it followed, only if they were prepared to pay high interest rates. Kings might force loans on their subjects, but this risked fomenting a rebellion. They might pledge the crown jewels as collateral to their foreign lenders. But such hypothecation, much less loss of the royal patrimony in the event of default, might fatally undermine public regard for the sovereign.

Sovereign debt began its rise to modern levels, therefore, only with the creation of representative assemblies in which the creditors sat and were empowered to oversee tax collection, approve increases in spending, and authorize additional debt issuance. With the creation of such assemblies, first in Italian city-states such as Florence, Genoa and Venice and then in the Netherlands and England, costs of borrowing came down. Sovereign debt came to be recognized as an obligation of the state rather than the individual occupying the throne.

The rise of public debt also had economic preconditions. In order to place debt in private hands, there had to be a population of individuals with adequate savings to invest. Not surprisingly, we see the successful placement of public debt in private hands at the same times and places where commercial activity was expanding. Venice, Genoa, the Netherlands, and Great Britain, which were among the public debt pioneers, were all leading naval and commercial powers in their day. Similarly, French towns that were home to the Champagne fairs were among the first jurisdictions to successfully market what today we would call government bonds ("life rents" or "*rents*").

Finally, successful debt issuers had to meet financial preconditions. They had to create secondary markets on which debt securities could be bought and sold, allowing investors to diversify their claims and limit their risks. Eventually they created an entity, a central bank, to backstop this market, ensuring its stability and liquidity.

In turn, the existence of this stable and liquid market encouraged private financial and commercial activity. As government debt securities came to be seen as safe and liquid, they were accepted as collateral for other borrowing and lending. Thus, the growth of transactions in public debt spurred the broader process of economic and financial development. Scholars sometimes ask: "Why Europe was first?" Why was it the first part of the world to experience modern economic, financial, and commercial development? Its precocity in issuing public debt is not the entire story. But it is a part.

## 5. Debt evolves

Over time, there was then further evolution in the uses to which public debt was put. Financing wars remained of premier importance. World Wars I and II thus saw the two largest public debt explosions of the 20th century. But governments borrowed in addition to invest in roads, railways, ports, urban lighting, and sewers – the infrastructure associated with modern economic growth. Issuing debt to finance these projects made sense, insofar as construction took time. As the returns rolled in, in the form of higher tax revenues or user fees, they could be used to service and amortize debt.

In addition, governments issued debt to finance social programs and transfer payments. Like the national defense, these public spending programs lent legitimacy to the state. They showed that government was prepared to insure its citizens from risks against which individuals couldn't adequately insure themselves.

Why these social programs couldn't be financed mostly, or even entirely, out of current revenues is less obvious. Part of the answer is that demand for spending on such programs is most intense when times are tough – when the economy is doing poorly, unemployment is high, and government revenues are growing slowly. Political fractionalization, another characteristic of our modern world, is another part of the answer. In a fractionalized polity, each political faction, while regarding certain social programs as indispensable, will tend to have just enough power to block taxes on itself but not enough to impose taxes on others. Finally, electoral uncertainty may lead politicians to advocate more spending on their preferred programs when in office, since they may be in a weaker position to push such spending later, and since the additional debt incurred today will be someone else's problem tomorrow. So, with the broadening of the electoral franchise and greater electoral uncertainty, public debts shot up.

It was at this point, in the last part of the 20th century, that public debt acquired its bad name, as debts exploded, especially in polities characterized by political fractionization and electoral uncertainty. The duty of responsible political leaders, the conclusion followed, was to reduce heavy debts to more sustainable levels. Leaders did what they could, some successfully, others not. In many places, debts remained uncomfortably high.

## 6. Will today's more tolerant attitude persist?

The public health emergency starting in March 2020 was perceived as a crisis tantamount to war, and it elicited a warlike fiscal response. The question is whether the resulting sea-change in attitudes and actions toward public debt will persist. If the change in the fiscal landscape is simply the product of COVID, and no more, then shouldn't the intellectual tide go back out? Shouldn't we expect old attitudes cautioning against excessive debts to resurface when herd immunity is reached?

In fact, there is reason to think that this new, more tolerant view of government indebtedness reflects more than just the public health emergency. First, there has been a shift in attitudes about government spending that pre-dates COVID-19. Scholars such as Thomas Piketty were already worrying about rising income inequality and declining economic opportunity before COVID-19 and arguing for government to address these problems. Others, such as Raghuram Rajan, former governor of the Reserve Bank of India and current University of Chicago professor, were highlighting society's "fault lines," not just inequalities of income and wealth but also of education and opportunity There was growing recognition of the need for government to provide public goods – education, health care, basic research, transportation infrastructure, and climate-change-abatement measures – that are not adequately provided by private markets left to their own devices. This is what President Biden means when he refers to the need for government to "go big."

The result is a shift in attitudes toward the role of government in economy and society, conducive to an increase in spending whether or not corresponding revenues are there. Gary Gerstle, a U.S. historian at the University of Cambridge, distinguishes America's "New Deal Order" starting in the 1930s, when it came to be taken for granted that governments would be the main supplier of these public goods, from the "Neoliberal Order" starting in the 1980s, when Ronald Reagan and Margaret Thatcher ushered in an era of limited government and market fundamentalism. That even the U.S. and UK, where the "Neoliberal Order" was most firmly embedded, are swinging back the other direction suggests that bigger government, larger deficits, and heavier debts are here to stay.

In addition, there is less reason to worry about heavy debts and less urgency about reducing them because interest rates are low. Low interest rates in turn mean that advanced-country governments are actually devoting a smaller faction of GDP to debt service, despite the fact that they are now carrying considerably more debt. In the U.S., federal government debt service cost just 2 per cent of GDP in 2020, virtually unchanged from 2001, when the debt-to-GDP ratio was barely half as high.

Given current low interest rates, there is no immediate crisis of debt sustainability. The fiscal status quo can be allowed to persist.

## 7. Low rates forever?

Just why interest rates have been becalmed at low levels for a decade is disputed. Some say that the explanation is the high savings of Germany, Saudi Arabia, and fast-growing emerging markets such as China. In an integrated global market, their ample savings depress interest rates worldwide. Demography works in the same direction: life expectancy in the advanced economies has risen by nearly five years over the last three decades, and when people live longer and enjoy more years of retirement, they sock away more savings while working. Other observers suggest that interest rates have fallen because physical investment has declined with the shift from manufacturing to services and from factories to digital platforms. Whatever the cause, the result has been to confront more saving supply with less investment demand, resulting in lower interest rates.

There's no guarantee, of course, that interest rates will remain at their current low levels. The savings rates of oil-exporting economies could fall as the demand for their petroleum dries up. Consumption in China could rise to levels more customary for a middle-income country. Additional deficit spending by the U.S. and other governments in 2021 could so supercharge spending as to put upward pressure on rates. Low birth rates leading to slower labor-force growth could put upward pressure on wages, leading to cost-push inflation that is incorporated into higher interest rates.

## 8. What to do

Higher interest rates, when they come, will create a need to reduce debt-to-GDP ratios. If the last decades have taught us anything, it is that emergencies happen. There will be another global financial crisis, or novel coronavirus, or geopolitical event, or climate-change related disaster requiring governments to deploy their fiscal capacity. Having utilized that capacity recently, prudent governments should contemplate steps to enhance and restore it now.

The obvious way for reducing debt-to-GDP ratios is by running budget surpluses. But very few countries have succeeded in running large budget surpluses, for extended periods, on the scale that will be needed for heavily indebted governments to reduce their debt ratios to pre-COVID levels. The ability to sustain such surpluses for years, even decades, is especially limited in a polarized political environment. When political parties are poles apart on necessary and desirable reforms, the compromises needed to sustain fiscal reforms are elusive. Thus, dealing with post-COVID debt will be challenging for countries where political polarization has been rising for decades, and in which COVID-19 has only elevated it further.

Alternatively, central banks can allow inflation to accelerate. This will cause the growth of nominal GDP to rise relative to the nominal interest rate the government pays on its debt, at least for a time, since some of that debt is long term and its interest rate is fixed to maturity. A favorable nominal-growth-rate-nominal-interest-rate differential is one way that governments have reduced heavy debts in the past. With enough inflation, it could happen again.

So will the Fed, the ECB and other central banks tolerate much higher inflation? COVID-19 changes everything, it is said, so perhaps it will change central banks' inflation tolerance. Still, there are reasons to be skeptical that it will create a tolerance for significantly higher inflation. An inflation rate marginally above 2 per cent for some period, perhaps, but not more. By running inflation at significantly higher levels, to the surprise of investors, central banks would be inflicting losses on the pension funds, insurance companies, banks and individuals who hold government bonds. Populations are ageing. Older people dislike inflation for self-interested financial reasons, including that they invest in bonds. And they vote in disproportionate numbers.

Or we can attempt to grow out from under the debt burden. In other words, we can raise the denominator of the debt/GDP ratio. This is the ostensible goal of the European Commission's €850 billion Recovery and Resilience Facility. It is the rationale for President Biden's physical infrastructure, social infrastructure, and climate-change-related investment packages. But however, many leaders invoke their mantras of infrastructure, digitization, and green growth, they lack a magic elixir to produce faster growth. They can only hope.

All this is to say that there are no simple solutions. History shows that countries that have successfully addressed problems of debt sustainability without major economic, financial and political dislocations have done so by maintaining stable financial conditions, turning to fiscal restraint when the time was right, and growing their economies. Not addressing the problem from all three angles is a recipe for failure.