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POLITICAL MEANINGS OF PUBLIC DEBT

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Abstract

This paper aims to reveal the major meanings of public debt from the perspective of Constitutional Political Economy. The main argument of this new research program is that excessive public debt is a massive wealth transfer, intra- and intergenerational, both unjust (discriminatory) and inefficient. By financing of public spending through continuous borrowings, the contemporary States *extract in fact resources from alternative uses*, sacrificing material goods, usually more valuable, that can no more be produced, and human needs, usually more basic, that can no more be satisfied, now and in the future. As notes James M. Buchanan, leader of this school of thought, it is as if we would cut the fruit trees for firewood, thus destroying the orchard production forever. Excessive public debt is therefore incompatible with a good (just), prosper and democratic society. And the remedy is the adoption of Balanced Budget Rule in current Constitutions, tried and failed in the U.S. in 1995, but with chances of success in the European Union, by the Fiscal Treaty entered into force on January 1, 2013.

Keywords: public debt, constitutional political economy, Fiscal Treaty

1. Introduction

On January 1, 2013 came into effect *The Treaty on Stability, Coordination and Governance in Economic and Monetary Union* ('Fiscal Treaty'), signed by representatives of EU countries, except for the Czech Republic and United Kingdom, but including Romania, on March 3, 2012.

Based on the main objectives of the EU – „sustainable economic growth, employment, competitiveness and social cohesion" – the text of the Treaty contains the formal commitment of „Contracting Parties" to European economic policies as a matter of „common concern", aiming to promote a „strong economic growth", but by „sound and sustainable public finances", thus preventing the „government deficit becoming excessive" [*Treaty on Stability, Coordination and Governance in The Economic and Monetary Union*, http://www.kpmg.com/IE/en/IssuesAndInsights/ArticlesPublications/Documents/Tax/EUTreaty.pdf].

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To achieve these goals, the imposition of some precise and automatic correction mechanisms is required, so that Member States' budgets deficit should not exceed 3% of GDP at market prices and public debt does not exceed the threshold of 60% of GDP at market prices. Therefore, the Treaty stipulates the formal commitment of Member States to adopt the 'Balanced Budget Rule' as mandatory and permanent *constitutional* provision.

Theoretical elaborations on public debt of Public Choice School, later renamed Constitutional Political Economy, spanning over at least half a century, they are today more relevant than ever. Nobel laureate James M. Buchanan, a prominent leader of this school of thought, although he always considered himself as an academic, he has been an active participant in the global, not just American, political debate on the necessity of adopting the Balanced Budget Rule in various national Constitutions.

In a study from 1997 [1] Buchanan summarizes his views on this topic, presents his main arguments and respond also to the criticism expressed by some economists and skeptical lawyers. Some economists think that enforcing constitutional constraints would hamper the 'fiscal flexibility' of governments, but Buchanan rejects such an objection, arguing that this 'flexibility' is often nothing more than a budgetary 'manipulation' of current politicians and governments. And some skeptic lawyers claim that this rule would be difficult to enforce at the constitutional level. Buchanan also rejects this claim, showing how other constitutional rules were imposed and are generally respected. A new argument in this respect, we can add, is the very recent adoption of EU Fiscal Treaty, based on the budget balance rule.

In American context, this skepticism was nourished by the approval by the U.S. House of Representatives, on January 26th 1995, of a constitutional amendment that requires the balance of the federal budget starting in 2002. However, on 2nd of March, lacking a single vote, the U.S. Senate has failed to approve this amendment.

Buchanan noted at that time that insufficient support of 'the political class' for the enactment of the amendment is based on some 'serious misunderstandings' as well, not only on individual and groups selfish interests which want to maintain high levels of government spending financed by increasing debt.

This article aims to reveal, from the perspective of constitutional political economy, an emerging subfield of political science, the major theoretical meanings and massive practical effects of enforcing this constitutional rule. In effect, as Rudolf Goldscheid, a classic author noted long time ago, "the budget is the skeleton of the State stripped of all misleading ideologies" [2].

2. A brief history of the theory of public debt

Reflection on the meanings of public debt seems as old as the history of organized societies. In the Bible we find not only explicit references to this practice, but some severe evaluations of its general significance: "For the Lord, your God will bless you as he has promised, and you will lend to many nations but you will borrow from none. You will rule over many nations but none will rule over you.” (*Deuteronomy* 15.6)

In modern and contemporary times, however, there are three main schools of thought on public debt, each trying, in terms of its own theoretical perspective, to reveal the significance of this phenomenon, to explain its societal, general causes, and to propose remedies there, when and if deemed necessary. The three major schools are: *classical liberal*, *Keynesian or social democratic* and *constitutional political economy*. In a philosophical parlance, the first is *thesis*, the second is *antithesis* and the third is *synthesis,* which contains the previous two and, in the same time, tries to *overcome* them.

Liberal political economists were generally reluctant to large public debts, arguing that governments don’t provide in fact genuine productive goods and services, but by taxing and/or borrowing they extract in fact valuable resources from the private economy, unduly burdening current and future taxpayers, threatening to cause long-term insolvency and even economic ruin of their societies.

David Hume, Adam Smith or David Ricardo, all argued that governments should ‘live within their means’ and these means must be limited. They must collect some taxes to fund national defense, justice, to guarantee the safety of citizens, property and contracts, and to finance public schools and basic infrastructure of society (such as roads, bridges, canals, etc.). Governments must be as cautious as a good family, in order to have a balanced budget without costly and burdensome debts.

According to David Hume, for instance, the public borrowing is “a practice which appears ruinous, beyond all controversy… either the nation must destroy public credit, or public credit will destroy the nation”, because brings with it “poverty, impotence, and subjection to foreign powers” [3].

In his turn, Adam Smith argued against public debt to the extent in which it finances unproductive and even wasteful government spending, which ‘enfeebles’ and even ‘ruin’ nations. “The progress of the enormous debts which at present oppress, and will in the long-run probably ruin, all the great nations of Europe, has been pretty uniform”, wrote Smith in 1776 [4]. He viewed the public debt as similar to the private debt, recommending that not only families or firms, but governments as well “to live within their means”, because “what is prudence in the conduct of every private family can scarce be folly in that of a great kingdom.” [4, Book IV, Ch. II]

David Ricardo argued that the true burden of government on the private economy lies right on its spending, whether financed by taxes or borrowing (which are nothing more than a ‘deferred tax’ in the future), because in both cases there are extracted productive resources from the private economy, reducing the well-being of the society [5]. This idea was later formalized as the ‘Ricardian equivalence’ theorem that will challenge the Keynesian claims that deficit spending contributes to the increase of national wealth [6].

By contrast, Keynesians and social democrats think that by borrowing governments not only provide productive public goods and services such as various public infrastructures of modern and contemporary societies, but it also remedies depressions and economic stagnation [7]. They argue that public spending funded by borrowed money can stimulate economic growth and increase employment, which does not burden, but rather provides benefits to current and future generations of citizens-taxpayers. And when public debt becomes excessive, they declare it as unjust and even 'odious', often recommending *implicit default*, i.e. the deliberate devaluation (inflation) of national currencies.

As James M. Buchanan summarizes, this school of thought is based on three main assumptions: "(1) The creation of public debt does not involve any transfer of the primary real burden to future generations; (2) The analogy between individual or private debt and public debt is fallacious in all essential respects; (3) There is a sharp and important distinction between an internal and an external public debt." [6] And the standard argument, that constitutional economists consider as fundamentally wrong, has been provided by Abba P. Lerner: "By far the most common concern about the national debt comes from considering it as exactly the same kind of thing as a private debt which one individual owes to others…. One of the most effective ways of clearing up this most serious of all semantic confusions is to point out that private debt differs from national debt in being *external*. It is owed by one person to *others*. That is what makes it burdensome. Because it is *interpersonal* the proper analogy is not to national debt but to *international* debt…. But this does not hold for national debt which is owed by the nation to citizens of the *same* nation. There is no external creditor. 'We owe it to ourselves'." [8]

The totally specious nature of this analogy is particularly obvious in one of his earliest, but very eloquent expressions: "Les dettes d'un Etat sont des dettes de la main droite à la main gauche, dont le corps ne se trouvera point affaibli" (State debts are debts of the right hand to the left hand and the body will not be weakened) [9].

Finally, constitutional economists argue that governments can and should spend, including by credit, to provide society public goods and services which the private economy cannot provide, such as national defense, justice and police services, as well basic infrastructure of society, but warns that increased costs devoted to social assistance in current welfare states are unsustainable on long-term, undermine the economic growth and general prosperity of nations. One may say that if the conservatives liberals were often wrong heralding national ruin caused by debt, Keynesians and socialists instead often overestimated the 'incentive' virtues of government spending, including by public credit. This moderate, skeptical conception of constitutional economists was well anticipated by Alexander Hamilton long time ago: "The truth is, in human affairs, there is no good, pure and unmixed. Every advantage has two sides, and wisdom consists in availing ourselves of the good and guarding as much as possible against the bad." [10]

3. Tax and spend *vs.* borrow and spend

As we have seen, before World War II, the great political economists, politicians and even citizens themselves strongly believed to be unjust and even immoral for the government to spend more than it collects from taxes, except periods of extreme but temporary emergency such as war or natural disasters. This mentality did not require an explicit fiscal rule to be enacted in the Constitution.

With the advent of Keynesian macroeconomic theory in the ’30s and ’40s years of the last century, however, this conception was largely abandoned. According to this theory, the national budget is a strong tool by which a ‘wise and benevolent government’ may ‘fine tune’ macroeconomic processes, ensuring the general welfare by boosting growth and full employment [11]. In this view, any legal limitation on the exercise of fiscal governmental discretion (tax and expenditure policies) would reduce the effectiveness of macroeconomic policies of governments.

In this manner, political and even legal responsibility for government deficits weakened considerably. Unjust and inefficient intra- and intergenerational redistribution produced by financing government debt was ignored by shifting attention to *macroeconomic* ‘aggregate’ outcomes which is obscuring the *microeconomic* reality of costs and benefits of different citizens groups. Thus, democratically elected politicians, predictably responding to increasing demands of their constituents, are now practicing the ‘fiscal illusion’ [12] on a large scale, namely *to spend without taxing*, which is, in fact, *fiscal irresponsibility*.

If only some ideologically committed politicians would be guilty for ‘fiscal irresponsibility’ we might hope that, by periodic elections, they will be changed to others more accountable to the present and future citizens-taxpayers. But this expectation is not realistic, because the ‘fault’ is not basically theirs or of their constituents as participants to the democratic political process, but it is in the ‘structural rules’ under which this process occurs. “The structural flaw”, Buchanan categorically states, “requires structural correction, that is, constitutional constraint that will, effectively, change the basic rules for the fiscal game.” [1]

In the absence of a legal, even constitutional strong constraint, politicians easily approve governmental borrowings and expenditures for all kinds of real and imagined ‘needs’, because they are always appreciated by some, others or even all citizens. This ‘easy’ approval ignores, however, basic economic reasoning according to which *these resources are extracted from alternative uses*, sacrificing material goods, usually more valuable, that can no more be produced, and human needs, usually more basic, which can no more be satisfied, now and in the future.

By spending without taxing, covering deficits by continuous borrowings, politicians create societal, general undesirable, unjust and inefficient outcomes. It is obvious that these results would be different, much improved in a constitutional framework constraining politicians to collect taxes and then spend them.

Why are politicians different from individuals and private firms which also borrow money often to satisfy certain needs? The fundamental difference lies in the absence of any effective *individual liability* for paying the loan. Public creditors have legal claims on *all* present and future citizens of the state, not on the assets and income of some individuals and private groups. This does not mean that all citizens will pay the loan equally, but always the burden is borne mostly by *some* individuals and private groups. This illustrates once again the constitutional economy theory of differentiated, discriminatory costs-benefits which electoral, majoritarian democracy provides if it is unconstrained by effective and strong constitutional rules.

4. The rules matter

Political choices are made according to certain rules. In Romania, for example, presidential elections are held *as a rule* every five years, the parliamentary and local every four years; and it seems clear that their results would be different if would occur by other, different rules. This elementary observation shows that the 'rules matter', so that beyond the analysis of politics within the existing rules, we can examine the rules themselves, even in order to change them.

This is in fact one of the fundamental distinctions made by constitutional economy, by which it differs from conventional political economy: between political activity carried out *under the existing rules* (*ordinary politics*) and that seeking (the best) choice from all *possible rules* (*constitutional politics*) [13].

Situated in this conceptual framework, the whole debate about the constitutional guarantee of budget balance changes its stakes. Imposing this rule promises to improve fiscal outcomes of ordinary fiscal game to the extent that it limits the set of acceptable fiscal-political choices, *with no requirements of any moral or ideological major change of existing policy-makers.*

Certainly, it is always more difficult to change the rules during the game than before it starts. However, political-fiscal game is continuous, making it difficult to implement any change in the *status quo*, because it endangers the interests of current players. As J.M. Buchanan and G. Tullock argued long time ago [14], and *then* John Rawls [15], the major change of existing rules and political institutions is easier when citizens are unaware or ignorant about what interests will be thus satisfied or, conversely, thwarted by it. "Ideally", recently reiterates Buchanan, "basic change in rules, constitutional change, should be made only behind some veil of ignorance and/or uncertainty that is sufficiently thick to allow the individual to choose among the alternatives without explicit consideration of the particularized distributional impacts" [1].

Practically, and of course imperfectly, these impacts can be reduced if the constitutional change, once enacted, will be implemented in the future. (In the U.S., for example, balanced budget constitutional amendment, proposed but not adopted in 1995, was to be implemented in 2002, i.e. after seven years). This strategy reflects not 'political cowardice', but a realistic understanding of the logic inherent to public choice, in general and to the constitutional choice, in particular. Profound reason of legislating a transitional period is to minimize the shaking of people's expectations, whether as real-net contributors or, conversely, beneficiaries of the existing government programs, together with their political representatives [16].

The enactment of budget balance rule does not mean however to *constitutionalize* a particular political philosophy (say: liberal, not socialist) or a particular conception of macroeconomic policy. From the perspective of constitutional economy, there is a irreducible conceptual difference between the rules establishing *procedures* for making decisions and the rules that expect *outcomes* of adopted decisions. In fact, the most existing constitutional rules are formal, *procedural*, prescribing modalities by which political activity takes place – voting rights, regular elections, majoritarian government, etc. – but they cannot anticipate anything substantial about the outcomes that may be obtained from the application of these procedures. To reiterate the game metaphor, a game whose rules determine *par avance* the winners is not a genuine or authentic game. "When viewed in this perspective, a constitutional rule for budget balance is *procedural* rather than *substantive*. Such a rule does not constrain either the overall size of the public sector (the budget) or the composition of the activities within that sector." (my italics) [1]

The constitutional provision, once enacted, requires only a new rule for adoption of public policies. It does not impose the policies themselves, whatever they may be. It requires only, but in an imperative manner, that the parliamentary and governmental majorities, whatever they may be, but like all ordinary citizens, to 'pay' (extracting taxes) for what they 'buy' (votes, political support) from their current constituents.

5. Budget deficit – democratic deficit

The opponents of constitutional rule often accuse the 'fiscal flexibility' limitation of governments. And, indeed, the rule constrains to some extent the tax choices of policy-makers. But the important issue here is that of the 'model' for understanding and predicting their behavior, both individually and in their interaction within institutional structures they inhabit. From this perspective, the 'most elementary prediction' that logically follows from the fundamental assumptions of constitutional economy is that, in the absence of effective, strong constitutional constraints, the current Welfare States based on representative democracy rather finance their public expenditure by borrowing than by (increased) taxation of the taxpayers, creating in this manner permanent deficits. [17]

Who pays public debt? And *when*? The peremptory answer of constitutional economy is that public debt is primarily a burden, unjustly and discriminatory transferred to the future generations of taxpayers of the state. The inherent logic of any debt, including public debt as financing of government expenditures, makes so that payment is to be transferred to a large extent in the future. Certainly, internal and external creditors borrow the state in a most voluntary manner, including in times of crisis, choosing among several investment opportunities the one that is safer and more profitable. But obviously, not those creditors bear the public debt burden so accumulated.

As creditor obtain a benefit (interest) in exchange for post-poning his current consumption in the future, so the debtor bears a cost (interest) for the opportunity to increase present consumption, paying once (and others) in the future. But, as suggestively Buchanan says again: “By financing current public outlay by debt, we are, in effect, chopping up the apple trees for firewood, thereby reducing the yield of the orchard forever.” [18]

The simply fact that borrowing has costs does not mean however that it is generally undesirable. A person or a private firm have good reasons to borrow for purchase a durable good or to finance a profitable, long-term investment; but less to finance, for example, an expensive vacation. This argument is entirely true for public debt also, to the extent that it finances *consumption*, not some profitable, *long-term investments*.

6. Conclusion

From the Great Depression until today Keynesian economists argue that the States may use financing debt as a means of *stabilizing the economy*. But this way of thinking completely ignores the relevance of general assumptions of constitutional economy. The elected politicians of current democracies show an irrepressible inclination, perfectly intelligible in terms of this theory, to use ‘public money’ to provide private, concentrate and short-term benefits to their voters, dissipating payment on others, present and future voters. The classical normative conception penalized, in general, the inclination to wasteful behavior, keeping inclusive government spending in the approximate income limits. Relaxation of this general ethical standard has a negative, dramatic effect on democratic politics. “Predictably, politicians responded by increasing spending more than tax revenues, by creating budget deficits as a normal course of events.” [19]

Such policies could give some good results if the State would have been led by a presumptive ‘benevolent despot’ or an ‘enlightened dictator’, but not in an electoral, representative democracy, with professional politicians organized in political parties, with a extended state bureaucracy and, not least, with citizens-voters who are both contributors and beneficiaries of government spending. In this landscape: “There is no center of power where *an enlightened few* can effectively isolate themselves from constituency pressures.” (my italics) [19, p. 98]

In fact, it is quite significant that Keynes himself, in his *Preface* to the German edition (1936) of his *General Theory*, admitted that: “Nevertheless, the theory of output as a whole, which is what the following book purports to provide, is much more easily adapted to the conditions of a *totalitarian state* [my italics] than is the theory of the production and distribution of a given output produced under conditions of free competition and a large measure of *laissez-faire*." [11]

To conclude, the excessive public debt is unjust, expressing a profound 'democratic deficit'. Beyond that it is predominantly used to finance current consumption expenditure and not long-term valuable public goods (e.g., administrative expenses of the state, not highways or other durable genuine public goods), its burden is transferred to the shoulders of future generations who cannot participate, even by representatives, to current borrowings and expenditures decisions. "'Taxation without representation' is literally descriptive of the plight of those who will face the debt-burden overhang in future periods." [18, p. 467]. If in the case of private debt the consequences of decreased welfare in the future are borne by the debtors themselves, by their income and assets, in the case of public debt people spend on credit without bearing the inherent consequences. As one commentator expressively said, rephrasing this idea in the Rawlsian conceptual framework, "we may say that behind a veil of ignorance people would not choose public debt to finance consumption" [20].

Finally, many European critics of balanced budget rule imposed this year by the Fiscal Treaty claim that it will ultimately undermine the 'European social model' of expanded welfare state. But this argument is incorrect and even specious. Anywhere in the world, including Europe, welfare states must finance their social expenditures mostly by income redistribution of current taxpayers for the sake of high ethical principle of solidarity between members of the same nation, not by public credit.

These critics also argue that the rule would establish a regime of permanent austerity, but this argument is wrong too, because it confuses, equally specious, the *procedural* character of this rule with the actual, *substantial* composition of state budgets. But within the large limits imposed by the balanced budget rule, democratically elected governments, together with their citizens, can make judicious choices between allocating appropriate resources for certain long-term investments, beneficial to the whole society, for present consumption or for helping those most in need of them. This is, after all, the ultimate constitutional choice of a 'good society'.

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