Chapter-2

HISTORICAL BACKGROUND OF PUBLIC DEBT
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Introduction

The role of public borrowing in economic development is relatively recent phenomenon and has much to do with the collapse of the principle of laissez faire, the rise of modern welfare states and imperatives of accelerated economic development of a considerable part of the world. An attempt would be made in this chapter to review the controversy about the burden of the public debt. It may not be a digression but a stopover on the main track in so far as it is concerned with the history of ideas, the clash of ideas, and finally a tentative movement towards a synthesis of conflicting views. Besides, such a study becomes important for two reasons:

(1) It may enable one to develop criteria with reference to which an assessment can be attempted of the burden of India’s internally-held public debt;

(2) A great deal depends on how people feel about the public debt and that the real limits to its expansion are possibly as much psychological and social as economic.

There is broad agreement on the institutional elements of public debt among economists but the theory or principles of public debt has been a matter of controversy for the last two hundred years. It is widely believed that resurgence of the “transfer hence no burden” argument
followed the Keynesian Revolution of the 1930s and was strengthened by the post Keynesian emphasis on deficit financing. It is largely true that Keynes himself gave expression to his views on the subject about ten years before the publication of the "General Theory of Employment Interest and Money," in his evidence to the Colwyn Commission in the following words, "I think it is a matter almost of indifference ..... It looks nice to have a clean balance sheet, and I think it is partly false analogy from private account-keeping; an individual likes to be out of debt. But for the nation as a whole it is merely a book-keeping transaction." However, in 1958 Professor J.M. Buchanan in his book 'Public Principles of Public Debt' summed up the basic tenets of what he called the 'new orthodoxy' and proceeded to demolish them one by one. The controversy relating to the burden of the public debt thus once again became a subject of lively debate in the late 1950s and 1960s and the position as of now is best stated in the words of Buchanan: "Prediction as to the development of analysis or the acceptance of ideas are risky at best, but it seems reasonable to suggest that the principles of public debt are on the verge of synthesis. Undue optimism is, however, surely to be avoided especially if the history of debt theory is to be used as a guide."
EARLY VIEWS

Nine years before Adam Smith's publication of the Wealth of Nations Sir James Stuart discussed the subject of public credit in his principles of political economy. He was one of the first to hold the view now upheld by the adherents of the "new orthodoxy" that public debt should function as the balance wheel of the economy. More importantly, Stuart explicitly held that .... "the country is neither poorer nor richer, when considered in a cumulative view, than if the same sum had been lent to private people at home." Instead "the effect of public borrowing on national debt is to augment the permanent income of the country, out of stagnating money and balances of trade".

There is little doubt that Keynes's ideas on economic policy, particularly on the role of taxation, public debt, public works and money as devices for correcting economic maladjustments, have a family resemblance to those of Stuart. Sen wonders: "it is indeed strange that this pioneer, who published his treatise nine years before Adam Smith's and in some respects may be said to have provoked the latter to write his Wealth of Nations by way of a reply has not received more than a passing reference from any of the important writers on the history of economic thought." Furthermore, "Unlike Adam Smith and Ricardo, by whom he has been completely over-shadowed, primarily because he had the misfortune to be out of tune with the zeitgeist of his period, his economic theory was a General Theory of Employment, Interest and
Money.”9 Stuart’s ‘evolutionist approach’ to economic analysis as opposed to the static approach of the classicist involved “studying an institution within its context and taking into account the fact of constant change in the institutional context.” He saw a positive economic role for the government and believed that the “steady development of democratic forms was giving the people a stake and voice in the government which in itself constituted the primary guarantee of responsible and non-arbitrary public debt management.”10 While Stuart was not unaware of the differential impact upon the various groups affected by the creation of public debt, overall income flow, the problem of distribution and consideration of general economic welfare led him to stress the role of government in promoting and maintaining economic prosperity through fiscal devices like taxation and public borrowing.

CLASSICAL VIEWS

It would appear that the views of the classicists on public debt depended on their faith in the role of government in the economic life of the country. Thus, in the nineteenth century and early twentieth century economists disapproved of the institution of public debt chiefly because of the classical rejection of the positive role of the state and the dogma of non-intervention. J.B. Say observes that “There is a grand distinction between an individual borrower and a borrowing government, that, in general, the former borrows capital for the purpose of beneficial
employment, the latter for the purpose of barren consumption and expenditure.”\textsuperscript{11} Say believed that the burden of the debt would be shifted “among a great number of successive years.”\textsuperscript{12} The only benefit of national debt which Say admitted related to a “national debt of moderate amount, the capital of which should have been well and judiciously expended in useful works”\textsuperscript{13} providing an avenue for investment of minute portions of capital which would otherwise have been idle. David Hume admitted that the merchants who can invest part of their funds in government bonds are in a position to trade upon lower profit and reduce the price of the commodities but held that there is “no comparison between the ill and the good which result from them.”\textsuperscript{14}

Adam Smith who never missed an opportunity to demolish what he called the sophistry of the mercantile system presumably criticised Stuart’s view on the public debt when he observed, “that the capital which the first creditors of the public advanced to government, was, from the moment in which they advanced it, a certain portion of the annual produce turned away from serving in the function of a capital to serve in that of a revenue; from maintaining productive labourers to maintain unproductive ones, and to be spent and wasted, generally in the course of the year, without even the hope of any future reproduction.”\textsuperscript{15} Smith dismissed the transfer payment argument as an “apology founded altogether on the sophistry of the mercantile system.”
Hume and Smith both believed that the collapse of public credit was inevitable. Hume and Smith both believed that the collapse of public credit was inevitable.

Ricardo, the greatest representative of the classical school, was convinced of the wastefulness of public expenditure and argued that “in point of economy” it would make little difference whether such resources were raised by taxes or by loans. Ricardo favoured heavier taxation and disapproved of public debt. He admitted that debt service involved transfer payment within the community but did not know whether the recipients of such income would “employ it productively” or “squander it unproductively”. Ricardo was greatly concerned with the effects of public debts because as he stated in parliament in June 1819, “National debt was an evil which almost any sacrifice would not be too great to get rid of. It destroyed the equilibrium of prices” and in December of the same year he stated that “the debt like the corn laws … raised the price of food and consequently the price of labour and therefore, reduced profits and tended to drive capital abroad.” He regarded public debt as “the overwhelming encumbrance which palsies all our efforts.” On the question of shifting the burden of the debt to future generations Ricardo was explicit that “the argument of charging posterity with the interest of our debt, or of relieving them from a portion of such interest is often used by otherwise well informed people, but we confess, we see no weight in it.”
James M Buchanan correctly observes, “This idea was, in fact, based upon his assumption that future tax payment would be fully capitalised in a world of rational individuals. If tax payers living during the period of debt creation fully capitalise future tax payments, the interest payments do become mere transfers which involve no “sacrifice” on the part of future generations.”

The foregoing discussion makes it sufficiently clear that Adam Smith, Hume, Say and Ricardo disapproved of public debt because they thought it interfered with the natural order which was conducive to the creation of wealth and increase in the material welfare of the nation. Their contention which was coloured by their conception of the natural order led them to ignore the distinction between creation of public debt as such and the effects of public expenditure.

J.S Mill – a major figure among classical economists – was in the line of classical thinking on the subject but he noted the paradox of apparent prosperity in the midst of capital destruction during the war years through loan finance and concluded erroneously that “the breach made in the capital of the country is thus instantly repaired, but repaired by the privations and often the real misery of the labouring class.”

The classical formulation of public debt found its best expression only in the last two decades of the 19th century in the work of H.C Adams, C.F Bastable and P Leroy – Beaulieu. They made a distinction between the creation of public debt per se and the effect of public
expenditure. Adam Smith held that "a loan calls for no immediate payment from the people ... the lenders are satisfied, since they have secured a good investment."^24 He refuted the argument that the burden of the expenditure cannot be shifted forward in time."^25 Bastable stated that public credit is only one form of credit in general and is governed by the same principles which control private credit. While admitting certain special features of public economy that impart to public borrowing certain peculiarities, he explicitly maintained that the analogy between private debt and public debt still held and clearly implied that the burden of the debt can be shifted on the future generation. Making a distinction between loan and tax finance he wrote, "A loan is voluntary and supplied by willing givers, taxation is levied on the willing and unwilling alike ... To make things smooth for the present at the cost of the future is not the duty of the wise and far-seeing statesman."^26

He felt that it was only partly true that loans are made out of capital and taxes are paid out of new income. Public debt affects income as well as capital and taxation affects capital as well as income.

"Large public borrowing stimulates saving and thereby checks expenditure on enjoyments while oppressive taxes reduce the fund from which new savings are made and so far hinders the accumulation of capital."^27
On distribution of the burden of the public debt he held that, “the equitable distribution of heavy taxation is not easily attained where very heavy imposts are laid on some classes and persons are likely to suffer unduly. The division of the charge over longer period by the use of borrowing makes the apportionment of the burden far easier and more specially allows sufficient time for its full consideration.”

Bastable considered resort to loan finance for other than economic purposes even for a lengthened period defensible under certain conditions. Furthermore, he maintained that a foreign loan in its purely financial bearings is not so different from a home one as is sometimes supposed and that “from a purely financial point of view the source of the loan is really immaterial. In any case it is an immediate relief to tax payer counterbalanced by greater charge in the future.”

Paul Leroy-Beaulieu in one of the clearest expositions of the classical position refuted the 18th century ideas on public debt and the sophisms of Melon and Voltaire who held that a state which is indebted to itself is not impoverished. He very rightly remarked that a public debt is in and of itself neither a good nor an evil. He criticised the classicist also for their failure to see that public expenditure can be productive. As he puts it, “a loan will be useful or harmful to the society in general depending on whether the state preserves and usefully employs the proceeds or wastes and destroys the capital which the rentiers have given up. In the past the passions of sovereigns and the mistakes of
governments have had for an effect the disbursing of the great part of the proceeds of public loans for useless expenditures. This has led many to condemn public credit absolutely, as an instrument of evil. This conclusion is exaggerated. It is as much as to say that it would be desirable for a man to be without sense because he often does not use it properly.\textsuperscript{31}

Marshall contents himself with the mere mention of the fact that the work of credit in the modern age differs from that of earlier times.\textsuperscript{32} but Wicksteed clearly states, “when two nations are at war and one of them raises a loan the person who actually finds the resources required may belong to the borrowing nation, or to neutral nations, or even to the nation with which the country is at war, but the obligation to pay is taken by the borrowing nation in its collective capacity and will be handed down to its posterity or successors.”\textsuperscript{33} In one sentence Wicksteed thus demolished the basic tenets of the ‘new orthodoxy’.

The dominant views of the classicists on the public debt can be stated in the following set of propositions:

1) Government loan finance withdraws funds from productive private employment.

2) Deficits are less painful than current taxes. Unbalanced budgets therefore expand governmental activity and invite irresponsible governmental action.
3) Government borrowing makes future financing more difficult by increasing the proportion of the budget which must go for fixed charges and by increasing the amount of taxes which must be paid to finance the transfer of interest on the debt.

4) Loan finance is costly, public outlays financed in this way must be paid for twice—once in meeting the interest charges and once in amortising the debt.

5) Public debt leads to currency depreciation.

6) An all tax plan provides a guide for the transfer of resources from the private to the public sector.\(^\text{34}\)

**Views of modern economists (No Burden Doctrine)**

It is now widely acknowledged that economics of public debt in modern public finance was powerfully influenced by the Keynesian revolution which produced theoretical results entirely different from the body of economic thought existing at the time of its development.\(^\text{35}\)

Although Keynes had expressed himself on the national debt before the Colwyn Commission in 1926 as noted earlier, the scientific basis for the modern theory of public debt was provided by the General theory of Employment Interest and Money in 1936.\(^\text{36}\) The classical theory of public debt derived its validity and legitimacy from the unrealistic assumption of full employment and the unproductive nature of public expenditure. Unlike Malthus a century earlier the classicists ignored the role of distribution in maintaining the power of production.
through creation of the necessary stimulus to the continued increase of wealth. "Once the economist, in a more realistic mood allowed for unemployment, assumed elasticity in monetary supplies and agreed that government expenditure could be productive and need not necessarily be wasteful, the case for public borrowing was strengthened."\textsuperscript{37} Hansen, the leading exponent of the new fiscal policy in wide-ranging discussion of the growth and role of public debt holds that “public debt, taxes and changes in money supply are all part of a balancing mechanism ... A limited increase in the public debt tends to promote a wide distribution of property in so far as the new issues are purchased by thrift institutions .... A public debt internally held is not like a private debt. It has none of the essential earmarks of a private debt. The public debt is an instrument of public policy. It is a means to control the national income, and in conjunction with the tax structure to regulate the distribution of income.”\textsuperscript{38} However, the new theory in its purest form finds expression in functional finance which eschews “appeasement” formulation of all kinds in this respect and holds that “the absolute size of the national debt does not matter at all, and that, however large the interest payment that have to be made do not constitute any burden upon society as a whole.”\textsuperscript{39}

The proponents of the ‘no burden’ doctrine are concerned with a macroeconomic model which treats the economy as a unit and accordingly holds “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. A nation owing money to other nations (or to the citizens of other nations) is impoverished or burdened in the same kind of ways as a man who owes money to other men. But this does not hold for national debt which is owned by the nation to citizens of the same nation. There is then no external creditor, we owe it to ourselves."^{40} Professor Pigou whom Keynes singled out as the man whose writings represented the best in what was wrong lucidly stated that "loans raised from foreigners entail a burden represented by interest and sinking fund on future generations in the borrowing country. But interest and sinking fund on internal loans are merely transfers from one set of people in the country to another set so that the two sets together - future generation as a whole are not burdened at all ....... in the broad it is true and obvious."^{41}

Hansen observes, "whereas the debt was formerly an instrument through which funds were siphoned from consumption into savings, so recently it has become in part atleast, an instrument to siphon funds from savings into consumption"^{42}.

Public debt is said to introduce an element of rigidity in as much as interest payments become a fixed charge on tax revenue. This argument has been rightly countered by the fact of the increase from the long run stand point of the national income as a whole.
But it may, however, be conceded that the existence of a large public debt to some extent curtail the debtor’s freedom of action. Ratchford is of the opinion that “in the final analysis this is probably the most important economic disadvantage of the whole institution of the public debt and would seem to be more significant than the purely legal fact of bankruptcy”\textsuperscript{43}.

The ‘no burden’ thesis also relies on certain advantages of public borrowing. The economic effects of public debt should be assessed in the light of the nature of the expenditure for which debt is incurred and in terms of its income-generating potentialities. What is of importance is the net economic burden. “The fact that a man holds a good block of war loan and can rely on a nucleus of safe income may sometimes induce him to seek higher but less safe return on his other savings”\textsuperscript{44}. Through debt creation the government can tap savings streams, put the resources thus raised to productive use and bring about an increase in national income. The additional flow of income facilitates the payment of taxes to service the debt\textsuperscript{45}. At a time of unemployment increase in public debt contributes to current capital formation that would otherwise not have taken place and thus represent a negative burden on society, in the sense of an addition to the country’s stock of capital goods. Public borrowing promotes the development of more and more institutionalised sources of savings like banks, stock markets and insurance companies. These naturally seek fixed debt obligations whether gildedged private
securities or government bonds. People are enabled by reason of the public debt to invest their savings in government bonds. This gives them an added source of income and makes it possible for businessmen to trade for smaller profits. Furthermore, the bonds provide a ready source of credit when a businessman needs it for business operations. It helps curb consumption, encourages savings and promotes capital formation and makes it possible for the people of a country to improve their standard of living. From all this it does not follow that the greater the size of the national debt the better for the country. In matters relating to economic life the doctrine of balance or what Malthus called “proportion”\textsuperscript{46}, is of the greatest relevance.

J.M. Buchanan calls the currently dominant theory of public debt the “New orthodoxy” which according to him is based on three basic propositions. These are:

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.
3. There is a sharp and important distinction between an internal debt and an external debt,\textsuperscript{47}.

As regards the first proposition the exponents of the modern view hold that “we cannot mortgage the future”. Thus the generally accepted view since the end of World War II defines the burden as “the sacrifice
of scarce resources when the funds are spent ........ in the aggregate then no burden can be shifted from one generation to another, the shift is between groups in the same period. In times of war it is the generation that fights the war that gives up the use of physical resources". Lerner in a sweeping generalisation declares that "a project that uses up resources needs the resources at the time it uses them up, and not before or after". He says that this basic proposition "is quite independent of whether the project is public or private as of whether the debt is public or private". Only the project has to be financed internally. He admits that there is a way "in which the present generation can shift a burden on to future generation. Our proposition is only that this is not done by internal borrowing. We can impoverish the future by cutting down on our investment in capital resources".

Samuelson also makes the same point when he says that the main way that one generation can put a burden on a later generation is by using up currently the nation's stock of capital goods or by failing to add the usual investment increment to the stock of capital.

Pigou also argues in a similar vein in his oft quoted passage: "it is sometimes thought that whether and how far an enterprise or enterprises ought to be financed out of loans depends on whether and how far future generations will benefit from it. This conception rests on the idea that the cost of anything paid for out of loans falls on future generations while costs met out of taxes are borne by the present generation."
Though twenty five years ago this could claim some respectable support, it is now everywhere acknowledged to be fallacious\textsuperscript{53}.

The second proposition of the ruling theory of public debt is that the analogy between public debt and private debt is false. Harris observes that “The analogy does not hold”\textsuperscript{54}. Hansen quotes at length Jorgen Pedersen with approval: “An internal loan resembles ordinary borrowing (evidently he means private borrowing) only in a purely formal way and it is obvious that every analogy to private borrowing must be completely false”\textsuperscript{55}. And at the end of a long chapter on the growth and role of public debt Hansen himself concludes that it cannot be denied that the interest of the public authorities as distinct from the interest of the individual is complex and that is why the exponents of the no-burden doctrine argue that the second proposition is correct not with regard to internal debt but with regard to the external debt.

The third proposition of the modern theory of public debt is not independent of the first two but is their logical corollary. An external debt (owed to foreigners) does involve a net subtraction from the goods and services to the degree that we have to send goods abroad to pay interest on that debt. An internal debt (owned by the government to its own citizens) is quite different matter\textsuperscript{56}. Furthermore it is held that the burden of the external debt unlike that of the private debt can be shifted on to the future generations.
It is quite clear from the foregoing discussion of the views of modern writers on public finance that an internally held public debt does not involve a burden in the sense in which a private debt or an externally held debt entails a burden and that the burden of the internal debt involves no postponement of cost or burden in time. It has been observed that the dominant theory of public debt is really not a new fiscal theory. Keynes claimed to have accomplished in economic science what Einstein had done in physics and a Revolution in thought no less than a Revolution in society implies an upsidedown view of things and that change of emphasis in response to pressures of immediacy, which makes all the difference between the old and the new. This dominant view ruled supreme till the publication in 1958 of James M. Buchanan’s book which has been already referred to. Moreover, President Eisenhower in his state of the Union message January 7, 1960 declared: ‘Personally, I do not feel that any amount can be properly called a surplus as long as the nation is in debt. I prefer to think of such an item as a reduction on our children’s inherited mortgage.”
REFERENCES:


13. Ibid, p. 481


19. Ibid,


27. Ibid, p-673.


50. Ibid,

51. Ibid,


54. Harris, S.E. *The National Debt and the New Economics*, op.cit., p. 44.


