

# Fiscal sustainability and government solvency: the origin, development and nature of an ongoing 200-year old debate



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# Overview (1)

- Since the 1980s and early 90s fiscal sustainability resurfaced as an important issue
- Public debt/GDP ratios increased
- Shift from Keynesian to more classical policy
- The term ‘fiscal sustainability’ of recent vintage
- Concerns that lie at its heart are not, stretching back several centuries
- Paper shows how 200 year old debate resurfaced in different guises



# Overview (2)

- What is fiscal sustainability all about?
- Relationship to older debates, in particular the debate about government dissaving
- How sustainable are fiscal policies internationally?
- How did debate on fiscal sustainability and government solvency evolve?



# Overview (3)

- Rival interpretations coexisted and still coexist
- Debate is by far not over
- Range of distinguishable views, some closely related, others not
- Is absence of consensus formation deplorable?
- Some debates continue and yield a proliferation of views, with no consensus in sight
- Similar to an evolutionary development and – proliferation of views, some dominant, some strong, some weak



# Overview: Structure of paper

- 1) What is fiscal policy all about
  - 1.1) Debt and deficits
  - 1.2) Dissaving as the cause of fiscal unsustainability
- 2) How sustainable are fiscal policies internationally?
- 3) The evolution of the theory of fiscal sustainability
  - 3.1) Early views
  - 3.2) Keynes and the changing view on public debt
  - 3.3) The modern mainstream view: The return of classical morals
- 4) Recurring themes
- 5) Conclusion

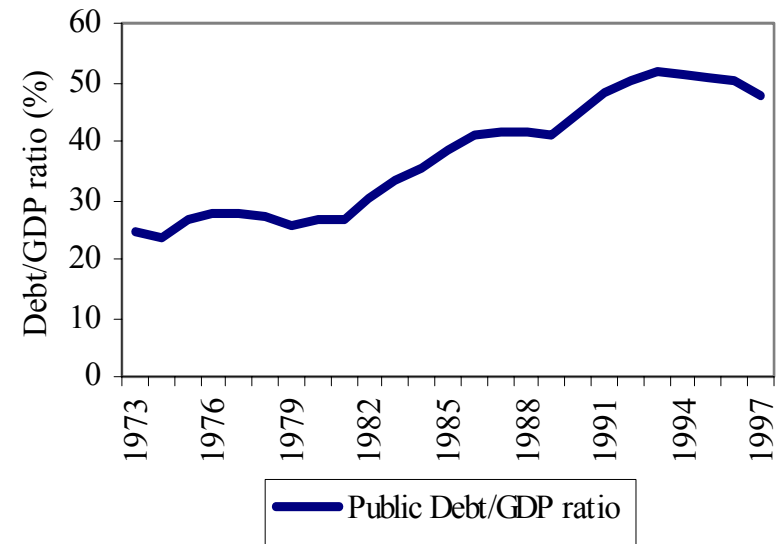
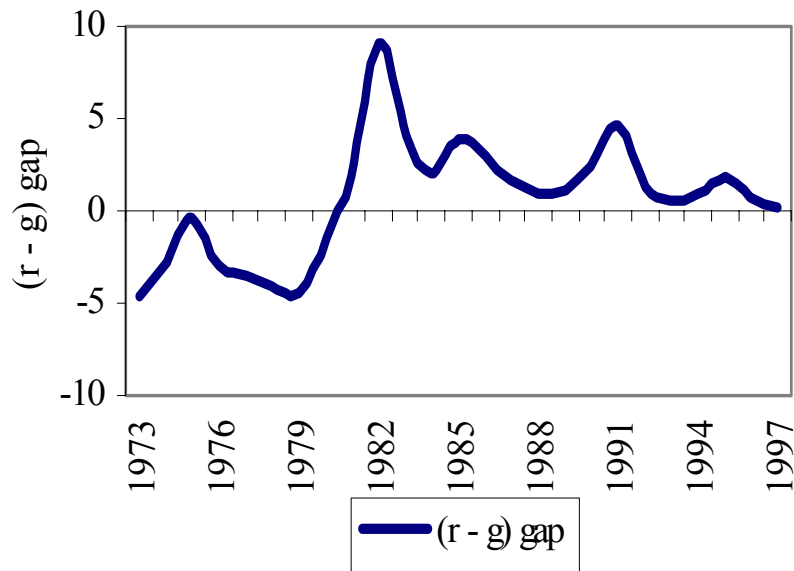
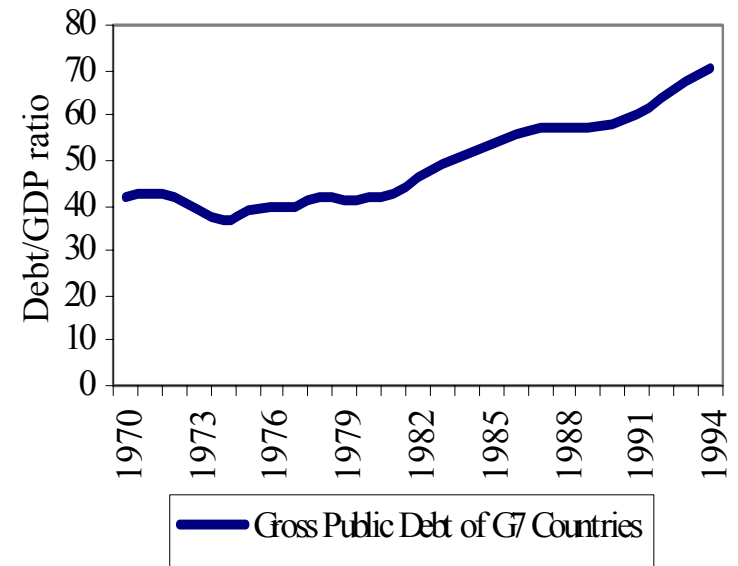
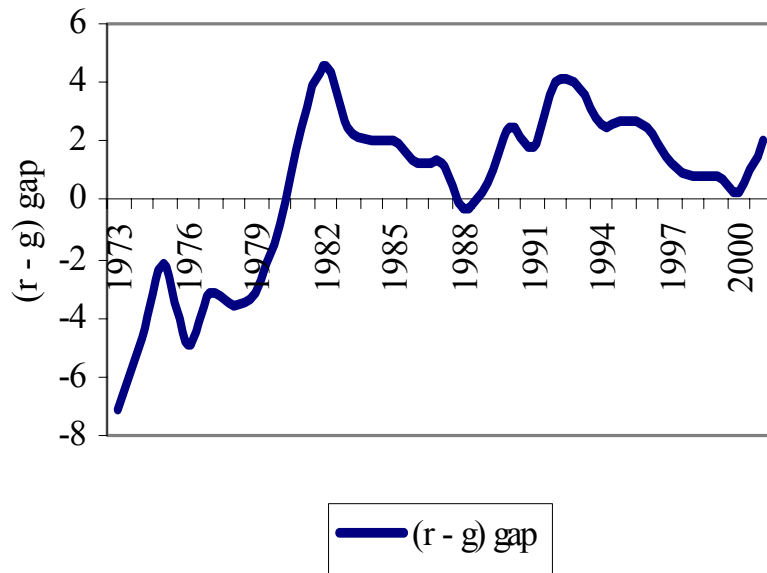


# Debt and deficits

$$\Delta D_{gt}/Y_t \equiv (r_{gt} - g_t)D_{gt-1}/Y_t + B_{gt}/Y_t + R_{gt}/Y_t$$

*$r > g$ : need to run primary surplus (negative  $B$ )*

*$r < g$ : can run a primary deficit (positive  $B$ )*





# Early views (1)

- Adam Smith quoting Pliny about Roman debt after Punic Wars
- Mundell relates how Venice accumulated debt in 13<sup>th</sup> century in its wars with Genoa
- Kaounides and Wood traces history of public debt in Great Britain back to revolution of 1688
- According to Schama rising public debt one of the reasons for the French Revolution



## Early views (2)

- Hume: “...either the nation must destroy public credit, or public credit will destroy the nation.”
- Adam Smith vs. Melon
- Melon: Payment of interest on public debt is like “...the right hand which pays the left.”
- Smith: redistribution from owners of land and capital stock to bondholders
- Ricardo: Burden of public debt reduces accumulation of capital; agrees partially with Melon on the effect of the payment of interest



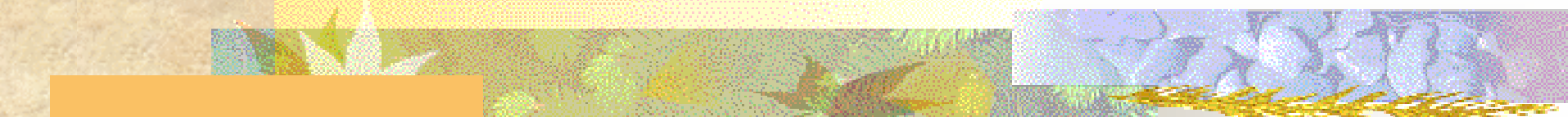
## Early views (3)

- Mill: No friend of public debt either, but recognises need for public debt when:
  - Foreign loans that absorb excess foreign saving
  - Government borrowing generates saving that would otherwise not have taken place
  - Government borrowing absorbs saving that would have gone in unproductive investment or foreign investment – the former prevents an over-accumulation of capital
- In all other cases government borrowing absorbs saving that would have financed productive investment



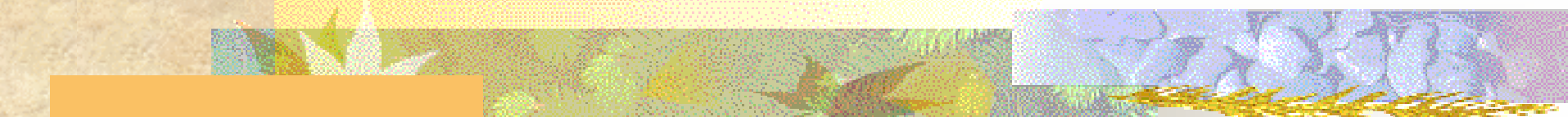
# Early views (4)

- Malthus: Only dissenting voice even though he warns against excessive debt:
  - Over-saving may cause *general* shortage in demand or *effectual* demand
  - Disagrees with Ricardo who held that excess supply in one market must equal excess demand in other(s), i.e. *aggregate* demand equals *aggregate* supply
- Malthus: Shortage of effectual demand introduces a role of public debt and especially for the interest on public debt, as it:
  - “...contribute[s] powerfully to    distribution and demand;...; they ensure the    effective consumption which is necessary to give the    stimulus to production;...”



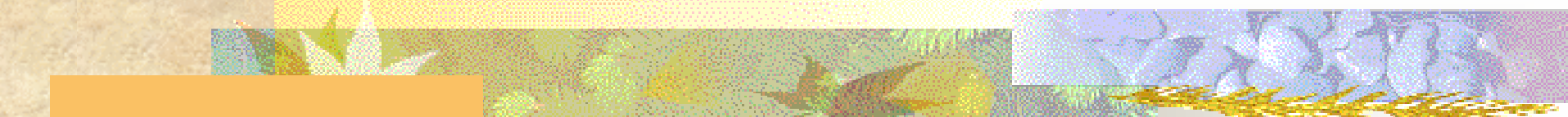
# Keynes and changing views on public debt (1)

- Classical view reached its most refined state in the *Treasury View* in 1929, just prior to Keynesian revolution. Next two decades saw renewed interest
- Great Depression and active deficit policy
- WWII yielded high public debt/GDP ratios
- Kalecki and public debt that finances itself
- Schumacher argued that deficits absorb saving that would not have been absorbed
- Lerner and *Functional Finance View*



# Keynes and changing views on public debt (2)

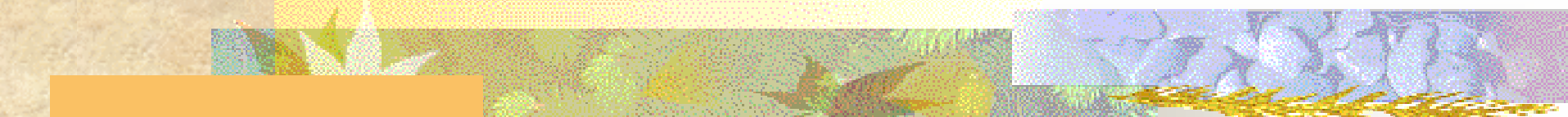
- Lerner: Use deficit finance to pursue full-employment
- If output below full-employment: no fear of inflation
- Money creation and domestic borrowing to finance deficit
- Size of public debt naturally limited
- Repayment of domestic debt and interest: Like right hand paying the left (Heilbronner and Bernstein)



# Keynes and changing views on public debt (3)

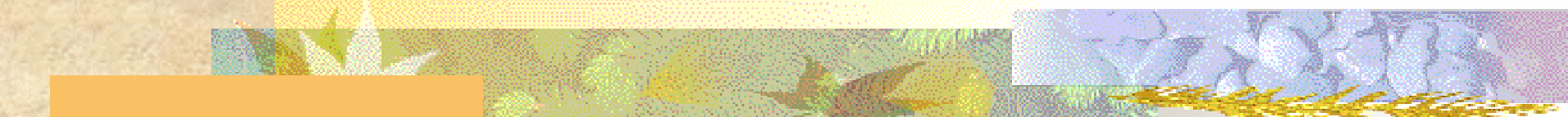
- Hansen: Public debt as ratio of income
- Multiplier too small, so deficit implies future increase in taxes

“Federal expenditure in the ...United States will certainly be so high that if taxes do not exceed interest payments on the debt..., we should experience inflation”
- Hansen vs. Lerner



# Keynes and changing views on public debt (4)

- Most sophisticated analysis of fiscal sustainability that by Domar – Father of formal mathematical treatment
- Did not call for reduction in debt, instead calls for increase in deficit so as to raise growth rate above interest rate, i.e.  $g > r$
- Via multiplier wants to grow economy out of debt burden. Argues that the problem “...does not lie with the deficit financing as such, but in its failure to raise national income.”



# Keynes and changing views on public debt (5)

- Difference between Hansen and Domar: Hansen considers the impact of deficits on inflation, Domar assumes constant price level because of unemployment
- Contributions of Domar, Lerner, Kalecki related to the earlier views of Malthus



# Modern mainstream view (1)

- Following 1940s less attention was paid to theory on fiscal sustainability. Domar seemed vindicated due to high economic growth rates and low interest rates
- Changed in early 1980s:  $r > g$  in 1980s and 90s
- $r > g$  represents prudent policy because it is more likely to prevent inflation (cf. Sargent and Wallace 1981 and Eltis 1998) and the economy is dynamically efficient (cf. Diamond 1965)



# Modern mainstream view (2)

- Differences between Domar model and modern mainstream: Domar assumed low interest rate that is unaffected by deficit, while modern theory argues that interest rates are affected by deficit
- Modern view agrees with Hansen that deficits may cause inflation when multiplier fail, Domar and Lerner believed in strong multiplier
- Modern view: Government cannot grow itself out of its public debt burden: Direct cure: reduction of non-interest expenditure or increase in taxes. Origin of this prescription already found in Ricardo



# Modern mainstream view (3)

- Horne and the difference between fiscal sustainability and government solvency
- Another angle provided by Galbraith and Darity and their 'Largest feasible primary surplus
- Argued also that deficits:
  - Stimulate growth
  - Do not displace private investment and raise profitability
  - Should be used to stimulate economy when there is unemployment



# Modern mainstream view (4)

- Arestis and Sawyer also fall in tradition of Galbraith and Darity.
- Agree that deficits do not crowd out investment, but rather crowd in investment
- Deficits should in times of recession be used to cause  $g > r$
- Reject the favouring of monetary policy over fiscal policy (lags issue)
- Link between fiscal unsustainability and government dissaving also features
- Question about the direction of causality between debt, deficits on the one hand and interest rates on the other



# Recurring themes

1) Level and repayment of domestic debt, interest payments and their influence on economy

Smith, Peacock vs Melon, Lerner, Heilbronner and Bernstein (Ricardo's hybrid view)

2) Ability of government to stimulate economy ( $Y$  and  $g$ )

Three lines of thought about power of multiplier and stabilisation policy

3) Dissaving issue

Smith, Mill and modern mainstream vs Galbraith and Darity as well as Arestis and Sawyer



# Conclusion (1)

- Overview of origin and development shows that nature is more than debate between two monolithic and unchanging sides
- Range of views, some closely related, others not and some representing ‘cross-breeding’ of views
- Hence resembles more an evolutionary development and -proliferation of views than the ideal debate where issues are debated, clarified and settled



## Conclusion (2)

- Development shows that interest in the debate resulted many times from real world experience.
- Debate reacts to and influences its environment
- Fiscal sustainability is a complex, multifaceted issue that generated heated debates
  - Expect the continuation of debate, watching for new themes to emerge and others to recur, particularly in periods when some consider public debt as too high