

STILL A NATIONAL BLESSING?
PUBLIC DEBT IN THE “POST-WAR” ERA.

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I have chosen to take Alexander Hamilton as the lynchpin for this talk because, not only was he one of the seminal figures in the history of public debt, but also because he was one of the first people to comment on its benefits in peacetime – and it is peacetime public borrowing which will inevitably be the major focus of this conference.

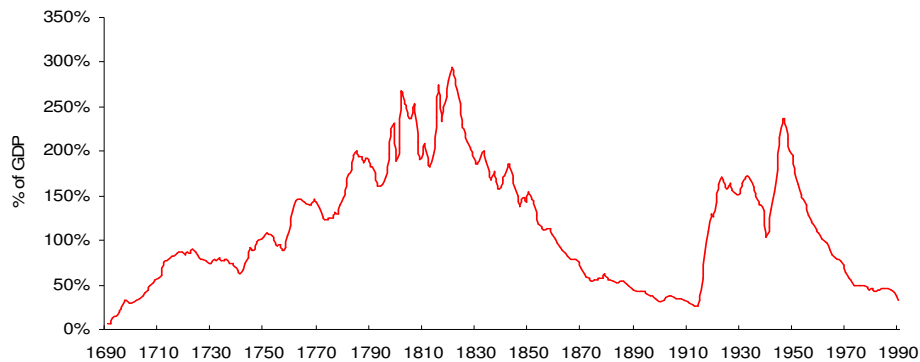
However, when Hamilton presented his Report on the Public Credit to the Congress in 1790, he was dealing, not with a peacetime debt, but with war debt – the debt accumulated in the War of Independence, which had been lying in default for the better part of a decade. His aim was to persuade a sceptical audience of the benefits of funding the debt. It was not an easy task because, as Galbraith once quipped, eighteenth-century Americans not only objected to taxation without representation, they also objected to taxation *with* representation. Hamilton needed some strong arguments, and it is scarcely surprising that his first line of attack was the crucial role of public borrowing in war finance. His argument ran that all nations needed to

borrow at times of crisis, and it was no use expecting to raise loans in wartime unless the credit of the nation had been firmly established in peacetime.

That Hamilton emphasised war borrowing is unsurprising; for the history of public debt up to the mid-twentieth century was intrinsically connected to warfare.

As an illustration of this point, here is a graph of British public debt from 1690 to 1990. It is scarcely too much to say that the entire financial and military history of the country over three centuries is summed up as the rise and fall of the debt to GDP ratio.

The history of Great Britain 1690 – 1990 as encapsulated by the debt to GDP ratio

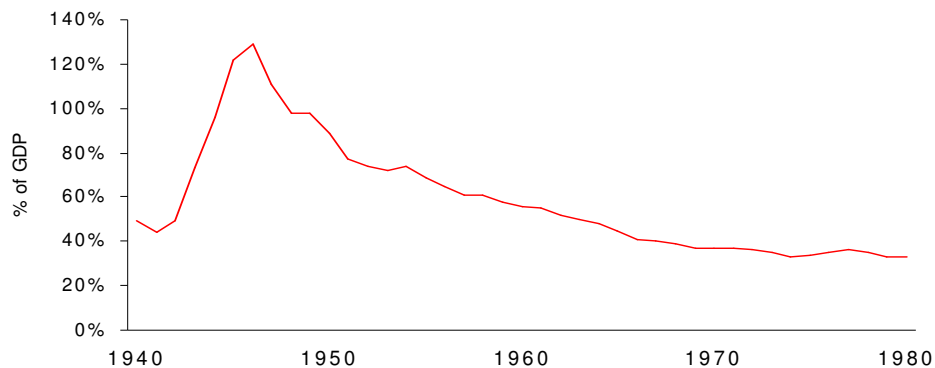


How clear the historical message looks. Two great waves of warfare – the first against France, the second against Germany – leading to massive peaks of borrowing, followed long periods of peace in which the debt to GDP ratio falls. The pattern appears straightforward - rising debt in wartime, falling debt in peacetime.

But, of course, the downward slopes from the two wartime debt peaks are not comparable. While it was true that the peacetime declines in the debt ratio were caused more by rising national income than by falling debt, the fact remains debt *was* repaid in every period of peace until 1945. However, since 1945 the very opposite has occurred. The debt-to-income ratio may have fallen, but no debt has been repaid. In fact debt has risen by leaps and bounds – from £23 billion in 1945 to £185 billion in 1990, and £570 billion in 2006.

I have used the British example because the historical connection between war and debt is nowhere clearer than in this country. The overall pattern, however, is similar in all the major western countries. 1945, therefore, marked a watershed. The era of warfare between the great powers was over, finished off by the new threat of nuclear Armageddon, and with died it the great era of war debt. A number of wars have been fought since 1945, but none of them requiring the kind of borrowing that created the dramatic peaks and troughs of the last graph. Vietnam is invisible in a graph of post-war American public debt – just as Britain’s colonial wars of the nineteenth century are invisible in the previous graph.

US public debt 1940-1980
the relative impacts of WWII and Vietnam



We are therefore living in an era that can be described as “post-war” not only in the traditional meaning of the term as the immediate aftermath of war, but in the sense of defining a new period of history. With the demise of war borrowing in 1945, a new era of peacetime debt was born.

Although Alexander Hamilton had used public debt’s wartime advantages as his first line of argument, he had also been at pains to stress its peacetime benefits – and in this he was, in many ways, ahead of his time. Are any of his insights of relevant today? Would he have understood the forces that have driven borrowing in the “post-war” era?

War debt was incurred to leverage national military power. It was not a hard leap to argue that peacetime debt could be used to boost the nation’s economic power.

Historically, the first method of applying this principle was already underway in the “war” period – even if it was insignificant compared to war debt. Writers on public finance increasingly distinguished between “dead-weight” and “active” debt. Dead-weight debt was caused by wars. “Productive” or “active” debt, by contrast, had been incurred for economically fruitful investment. Underlying this distinction was the public investment in railways in many countries in Europe and elsewhere during the nineteenth century. In Prussia, for instance, the income from the state railways considerably exceeded the interest on the public debt.¹

Curiously, given his interventionist attitude to the economy, Hamilton never proposed such a use of government borrowing. Perhaps he had not considered the possibility. However, it is noteworthy that he was one of the few Federalists who supported

¹ In 1913 Prussia had debts of 9 billion marks (out of the 22 billion marks total debt of the Reich and the states). Against this Prussia had 1.3 billion marks net income from state enterprises.

Jefferson's borrowing to fund the Louisiana Purchase – surely the most “productive” debt in the history of the world.

Since this talk is focused on the developed world, I am going to pass over “productive” debt somewhat cursorily – in spite of its historical importance. The problem with the idea of “productive” debt is that it was a slippery slope. Investment in the highly profitable Prussian state railways was one thing, but too many subsequent loans were raised for projects that were never intended to produce income. Even where loans were supposed to be self-supporting, too many of them ended up being a great deal less productive than originally planned. This is partly because of the poor track record of governments in picking economic winners, partly (especially in the developing world) because of corruption, and partly because political considerations have intervened, so that loans have been used to fund inefficient nationalised industries whose main role has been to provide employment rather than to create wealth.

For these reasons, “productive” borrowing has gone out of favour and no longer accounts for a very large amount of current levels of debt in western countries. A great deal of borrowing that occurred in the heyday of nationalized industry after 1945 has been offset by income from privatization since the 1980s.

A more subtle change in public finance occurred just before the Second World War. In the 1930s John Maynard Keynes established the intellectual underpinnings for a new, *macroeconomic* justification for public borrowing. The apparent failure of laissez-faire capitalism to find a way out of the post-1929 depression forced a rethink of the rules of economics. Out of the window went free trade and the gold standard, and with them went the traditional view of budget deficits. Now, it was argued that

governments should promote economic growth by running deficits when private consumption was insufficient for the purpose.

The idea of stimulating the economy by running a deficit was not one that Alexander Hamilton ever advocated. It is unlikely that it even occurred to him. Yet his justification of public debt in peacetime had much to do with macroeconomics. In his view, a properly funded public debt would promote economic growth in two ways. Government bonds would constitute a form of money, and thereby increase the money supply. "It is a well known fact," Hamilton informed the newly assembled Congress, "that, in countries in which the national debt is properly funded, and an object of established confidence, it answers most to the purposes of money. Transfers of stock or public debt are there equivalent to payments in specie." Additionally, Hamilton argued, a public debt that commanded popular confidence would lower interest rates not only for the government but for all borrowers.

Although this is not classic Keynesianism, it is worth noting that Keynes himself was a strong advocate of increasing the money supply and lowering interest rates as methods of stimulating growth. The essential link is the justification of public debt as a macroeconomic tool to maximise national income.

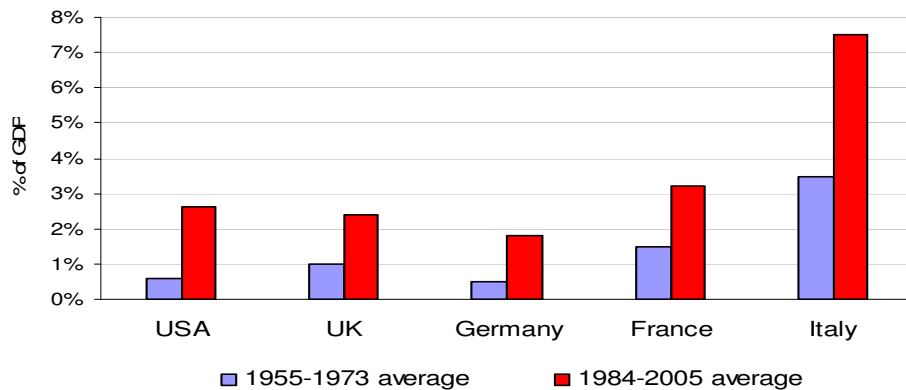
How far can Keynes's theories explain the inexorable rise of public debt in the post-war era? Certainly not directly. The logical outcome of Keynesian economics as described by its author was a long-term budget deficit of approximately zero, at least in times of peace and prosperity, since deficits at time of insufficient demand would be offset by surpluses as the economy reached full capacity.

The problem lay with the over-optimistic interpretation of the Keynesian panacea by politicians and economists in the post-war era. The result was the discredit of Keynes

and his ideas during the stagflation of the 1970s. In 1976 the British Labour prime minister was forced to admit that, in practice, Keynesian economics had led to ever-higher doses of inflation followed by ever-higher thresholds of unemployment.² In the United States, there were attempts effectively to outlaw Keynesian economics by passing a constitutional amendment requiring the budget to be balanced except in time of war. Even where Keynes's doctrines lingered, they were interpreted less ambitiously, amounting to little more than the deficits that would automatically arise in times of recession – "automatic fiscal stabilizers" as they are now called.

One might have thought that the waning of over-ambitious Keynesianism would have led to a return of long-term budgetary balance. It was not to be. In retrospect, the heyday of Keynesianism gave rise to budget deficits that now seem almost Victorian in their modesty. Deficit spending has been far higher on average since 1980.

The growth of government deficits in times of peace and prosperity³



² Jim Callaghan addressing the Labour Party conference in 1976. "We used to think that you could spend your way out of a recession, and increase unemployment by cutting taxes and boosting Government spending. I tell you, in all candour, that option no longer exists, and that insofar as it ever did exist, it only worked...by injecting bigger doses of inflation into the economy, followed by higher levels of unemployment as the next step... This is the history of the past 20 years."

³ The periods chosen deliberately exclude the oil-crisis and stagflation-ridden decade of 1974-1983 as one of peace, perhaps, but not of prosperity.

There are several possible explanations to this conundrum. One might be the existence of a covert Keynesianism - in which his principles are surreptitiously applied at the same time as his theories are officially discarded. This suspicion falls particularly on the Republican administrations in the United States since 1980.

Another possible explanation is the growth of a new, unofficial fiscal orthodoxy which parallels a new, official monetary orthodoxy. The old canon of financial rectitude required that budgets should be balanced except in time of war, and that the long-term rate of inflation should be zero. The new monetary orthodoxy gives central banks inflation targets not of 0% but of 2-2.5%, implying a continuous long-term depreciation of the currency. The new fiscal orthodoxy argues not for budget balance, but for stabilizing the debt to GDP ratio at a sustainable level, implying a constant increase in debt. The definition of a “sustainable” level varies, but the ideal is usually felt to be in the region of 30-40% of GDP.⁴ Gordon Brown’s “Golden Rule” makes 40% the threshold beyond which he can no longer be called “prudent”. The European Growth and Stability Pact has as enshrined 60% as the absolute limit before punishment is inflicted (in theory, although not in practice) on the fiscal sinner. In a world where inflation is targeted at 2%, and growth rates of 2-3% are considered “normal” (at least in developed countries), the new fiscal orthodoxy implies an annual increase in debt of 4-5% just to stay constant.⁵

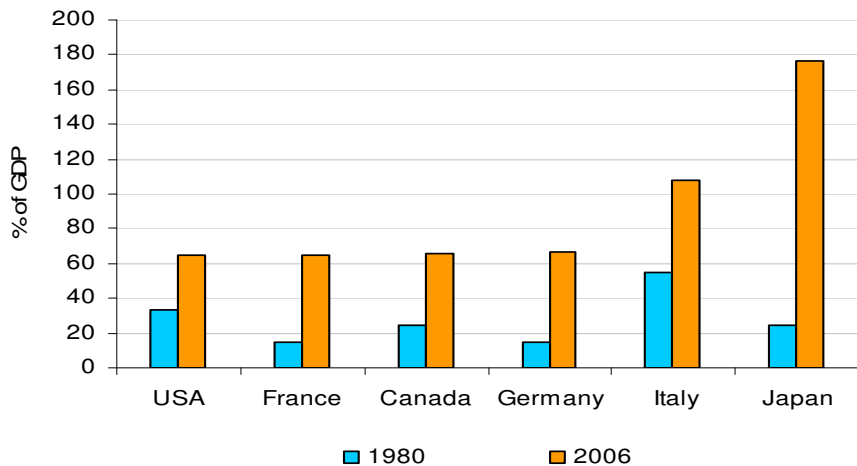
⁴ See, for example, Lawrence A. Hunter and Steve Conover, *Who’s Afraid of the National Debt?: The Virtues of Borrowing as Tool of National Greatness*, Institute for Policy Innovation, Washington, 2001. The authors argue for running deficits sufficient to keep the debt burden stable at around one third of GDP.

⁵ This logic is evident in the 3% of GDP limit on deficits under the EU’s Growth and Stability Pact. If inflation and growth are “normal,” then an annual deficit of 3% will keep the debt ratio stable at around 60% of GDP. On the other hand, the Pact does not endorse the idea of constant deficits. If anything it remains a repository of orthodox Keynesianism – deficits in times of stagnation or recession offset by surpluses in times of strong growth.

None of this would have made any sense to Alexander Hamilton. But he would certainly have recognised the virtues of another macroeconomic argument for a modest level of government debt. Hamilton argued that government bonds would form the backbone of the domestic capital markets that he saw as essential for the nation’s economic development. It is only fairly recently that his foresight has been fully appreciated. The same prescription for stable economic growth is now made for developing countries where domestic capital markets scarcely existed until recently. Government bonds serve several functions in financial markets: first, because they are invariably the largest and most frequently traded issues, they promote market liquidity; second, they provide tangible evidence of the government’s commitment to sound long-term financial policies; and third, they constitute a “risk free” asset which can be used as a benchmark for setting other rates.

Yet neither of these arguments for maintaining modest levels debt is sufficient to explain the current situation. Many countries find themselves with debts that have grown beyond even modern levels of fiscal prudence.

The growth of “imprudent” public debts



So, economic considerations will only explain modern peacetime borrowing up to a certain point. In order to have a full understanding, it is necessary to turn to politics – and it was here that Alexander Hamilton had a second line of argument in favour of peacetime debt.

The first political issue to be considered – although it is not in any way the Hamiltonian argument – is the nature of democratic politics. For all their successes, democratic systems of government have a hard time reconciling differences about the level and distribution of government taxation and spending. In a world in which some voters clamour for increases in social spending while others object vociferously to increases in taxation, and most do both at the same time, the outcome is often a budget deficit that puts off the hard bargaining. In such situations deficits are the unintended outcome of political stalemate. Some countries have constitutional arrangements that make stalemates more likely – for instance those with electoral systems that lead to fragile coalitions, or those where power is sharply divided between executive and legislative bodies. But even in the UK, where neither of these considerations apply, politicians are often tempted to borrow rather impose unpopular tax rises or budget cuts – especially as elections approach.

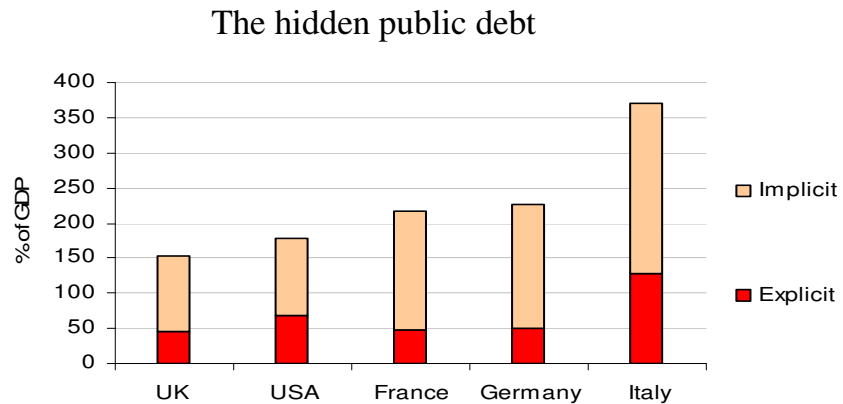
However, there are other circumstances in which deficits can deliberate political tool. The deficits of the Reagan and George W Bush administrations occurred at least in part because they were seen as a means of forcing long-term spending reductions on the Democrats.⁶

⁶ David Firestone, *Conservatives Now See Deficits as a Tool to Fight Spending*, New York Times, February 11, 2003. He quotes Milton Friedman: “Deficits will be an effective – I would go as far as to say, the only effective – restraint on the spending propensities of the executive branch and the legislature.”

Here, perhaps, is a good example of politics outweighing macroeconomics. The Reagan deficits may have been “Keynesian” in their effect, but they were far from being the product of a Keynesian consensus. The process that created them was a combination of deliberate political manoeuvring and unintended political stalemate between a Republican president and a Democrat-controlled Congress.

Hamilton would undoubtedly have been horrified by such political shenanigans. However, he would have recognised a second “political” element in contemporary debt – even if it was not in the form that he envisaged in the eighteenth century.

One of the biggest forces fuelling deficits in recent decades is pressure from a form of debt that is rarely, if ever, recorded in the public finances. The conventionally measured debts of most countries, whether developed and developing, are dwarfed by their implicit long-term liabilities for state pensions. The techniques for measuring implicit debt are not universally agreed, but some sense of their scale can be seen in this chart.⁷



⁷ Figures as of 1990. From Robert Holzman, Robert Palacios, Asa Zviniene, *On the Economics and Scope of Implicit Pension Debt: An International Perspective*, Emprica, 2001

State pensions have always been political. Bismarck, who is generally accepted as their founding father, justified his proposal on the grounds that he would “consider it a great advantage when we have 700,000 small pensioners drawing their annuities from the State, especially if they belong to those classes who otherwise do not have much to lose by an upheaval and erroneously believe that they can actually gain much by it.”

In other words, pensions would attach potential revolutionaries to the established political order. Expressed in this nakedly political fashion, pensions represented only a new twist on ideas that had already been articulated about traditional forms of public debt. Indeed, Bismarck noted that in France, the same political effect was produced by popular investment in *rentes*. In Britain it was achieved by the Trustee Savings Banks and by the Post Office savings system.

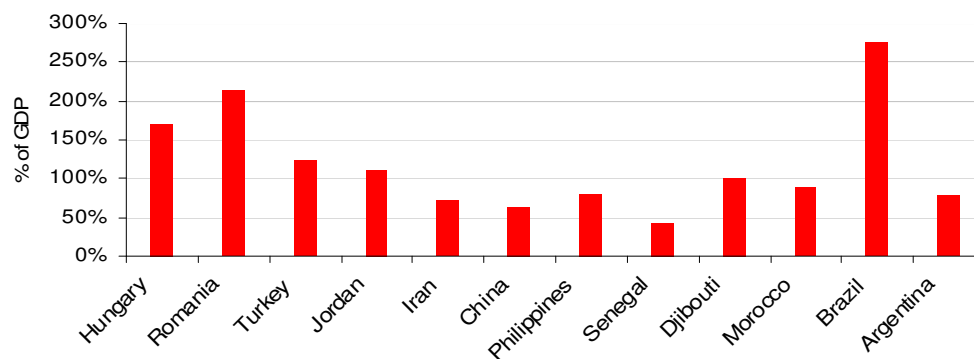
Bismarck’s argument would have been recognised immediately by Hamilton. One of the blessings of a national debt, in his view, was that it “attaches many citizens to the government who by their numbers, wealth and influence, contribute more perhaps to its preservation than a body of soldiers.”

It was not just supporters of public debt that held this view. In 1710, Jonathan Swift attacked the British national debt as a post-1688 Whigish scam designed to “fasten wealthy people to the new government.” In the nineteenth century, Karl Marx condemned postal savings schemes as “a golden chain on which the government holds a large part of the working class.” And in the late twentieth century, the Marxist writer Eric Schragge characterised state pensions as a trick of the capitalist state to

maintain a pool of quiescent labour to exploit, while “managing some of the negative consequences of capitalist production.”⁸

One of the wonders of state pensions has been their infectious appeal. By the post-war era they were to be found not only in the advanced economies of the West, but also in communist countries and in the Third World.⁹

Pension debts around the world



Their existence of state pensions in communist countries might seem strange given Marx’s views about “golden chains,” but the paradox is easily resolved. The utility of pensions in tying people to the state is equally effective whatever the nature of the government. This is one part of the explanation of their ubiquity.

On the other side of the equation, the original appeal of pensions to the general population lay in two things. First of all there was an element of redistribution that was built in, to a greater or lesser extent, into all public pension schemes. This gave them a particular attraction to large parts of the population. Secondly, modern state pension schemes have generally operated on a pay-as-you-go basis. This has meant

⁸ Eric Shragge, *Pensions Policy in Britain*, London, 1984, p.10

⁹ Figures as of 1999. From Robert Holzman, Robert Palacios, Asa Zviniene, *On the Economics and Scope of Implicit Pension Debt: An International Perspective*, Emprica, 2001

that the first generation of recipients, who were in a position to vote them into existence, have had significantly above-market rates of return on their contributions.

What we have here, then, is a “win-win” arrangement of mutually incompatible objectives. From the perspective of state, pensions appear as a form of clientelism – a buttress to political power. From the perspective of voters, in the meantime, they are a form of rent-seeking which would seem to justify Bastiat’s categorization of the state as no more than a “fictitious entity through which everybody attempts to live at the expense of everyone else.”

State pensions would probably have remained popular with governments if it had not been for one thing – the unanticipated rise of a new, intergenerational form of political conflict.

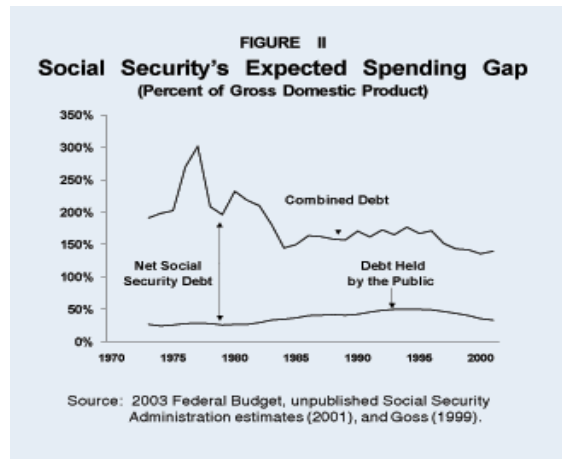
In a seminal paper published in 1958, the economist Paul Samuelson described state pensions as legalized Ponzi schemes, in that payouts to existing participants depended on money paid in by new entrants.¹⁰ But in his view this did not matter for two reasons. First of all, unlike private Ponzi schemes, the state could compel participation, so there was no risk of collapse; and second, as he put it: “there are always more youths than old folks in a growing population.”¹¹ In hindsight, it is easy to see what went wrong. Declining birth rates and increasing longevity have undermined Samuelson’s second assumption. The result is that pension schemes all over the world are facing a crisis. Either future working populations will have to pay massively increased taxes to support the ever growing ranks of state pensioners, or

¹⁰ Paul Samuelson, *An Exact Consumption-Loan Model of Interest with or without the Social Contrivance of Money*, *Journal of Political Economy*, 1958.

¹¹ Paul Samuelson in *Newsweek*, 1967, quoted in Sylvester J. Scheiber and John B. Shoven, *The Real Deal: The History and Future of Social Security*, New Haven, 1999, p.110. Samuelson went so far as to claim that “The beauty of social insurance is that it is actuarially unsound. Everyone who reaches retirement age is given benefit privileges that far exceed anything he has paid in...”

payouts to pensioners will be cut back. In this case, Samuelson’s unsinkable Ponzi scheme will in fact have collapsed, since there will be a generation that has not only paid for the retirement of its predecessors, but will also have to pay for a large part of its own.

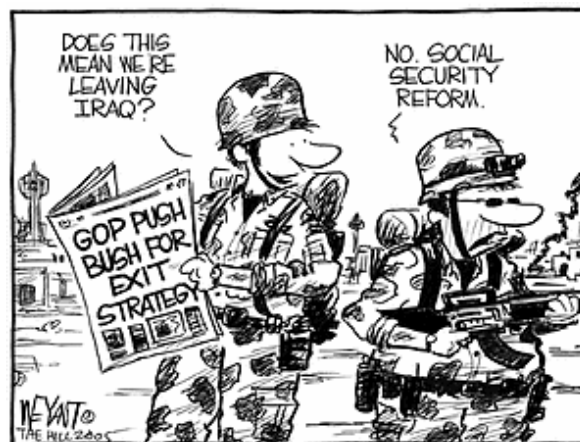
Governments are accustomed to dealing with income-based political conflicts – indeed for many political parties such conflicts have been their lifeblood. However, governments do not appear to relish their looming roles as intergenerational arbiters. They have been slowly but surely backing away. In retrospect one can see that the tipping point came in the 1970s – a point perhaps best illustrated by the United States. In 1973 the Nixon government enacted an automatic indexation of pension payouts that amounted to double inflation. By 1977 the Chief Actuary of the Social Security Administration was ringing the alarm bells so loudly that the decision was reversed by the Carter government. Since, unlike other countries, the US has always measured its unfunded pension liabilities, the historical peak of state pension generosity can be made visible in a graph.¹²



¹² The graph is from Andrew J. Rentenmeier, *How Big is the Government's Debt?*, National Center for Policy Analysis, Washington, June 2002.

The next landmark on the road of public retreat occurred four years later in Chile, where the state pension system was replaced by mandatory private savings accounts. At the time, the Chilean experiment seemed too idiosyncratic and radical to constitute an example for others, but in 1994 the World Bank gave it its seal of approval in a seminal publication, *Averting an Old Age Crisis*. Since then, an increasing number of countries, especially in Latin America and Eastern Europe, have moved towards privatized systems.

The advocacy of pension privatization may be seen as part of the neo-liberal “Washington Consensus.” Curiously, there does not appear to be any consensus on the issue in Washington itself.



It is an interesting reflection on the politics of public pensions that, although the United States is generally considered the natural home of free-market economics, the opposition to pension privatization has been stronger there than in many traditionally less market-friendly countries. This is a demonstration of the remarkable ability of state pensions to strike deep roots once established. Giuliano Bonoli, writing about the politics of pension reform in Europe, has stated perceptively that politics is shifting from its traditional left-right axis to a struggle between governments, to a

large extent regardless of their political persuasion, and coalitions of vested interests that seek to defend the status quo.¹³ So bound up are state pension systems with the political legitimacy of post-war regimes, that it has generally required looming economic collapse or regime change, or both together, to propel radical reforms.

One further political implication of pension reform is worth noting. State pension systems tie citizens to the state – this was, to an extent, their original purpose. Privatized pensions tie people to free-market capitalism. This is, to an extent, *their* purpose. In the words of José Piñera, the architect of Chile’s reform, “The most important aspect of pension reform is the paradigm shift it produces by creating a country of property-owning workers who favour free markets and free minds. Put simply, the rise of ‘worker capitalism’ would turn Marx on his head.”¹⁴

What would Alexander Hamilton have made of all this? It is, of course, impossible to know - but I am inclined to think that he would have been horrified. He would have been pleased that his belief in the binding power of public debt had been so amply demonstrated by state pensions, but the extent of the public indebtedness that they produced would have dismayed him. His opponents liked to accuse him of favouring the creation of a perpetual and growing debt; but Hamilton always protested that this was untrue. Like many of his contemporaries he was worried about the prospect of large numbers of people living off the public purse, which was one of the unfortunate results of large public debts. He feared that an excessive debt would serve “only to pamper the dissipation of idle and dissolute individuals” (although this is perhaps an unkind way to describe pensioners). He also noted that there was built into political life an inherent tendency to accumulate debt. To counteract this tendency it was

¹³ Giuliano Bonoli, *The Politics of Pension Reform*, Cambridge, 2000, p.38

¹⁴ José Piñera, *Putin the Great*, Moscow Times, May 28, 2004, quoted in Leon Aron, *Privatizing Pensions*, American Enterprise Institute for Public Policy Research, Summer 2004.

essential for a responsible government to make “a perpetual, anxious and unceasing effort to reduce” such debt as was necessarily incurred. Only in this way could the public credit be preserved for times when it was truly needed.

But of course, Hamilton took this cautious line because he lived in a dangerous era when war between the great powers was a constant threat. One cannot help wondering if it is not the very disappearance of this threat that has been the ultimate driving force behind peacetime borrowing in the “post-war” era.