The Citizen-Creditor and the Financial Roots of Democracy

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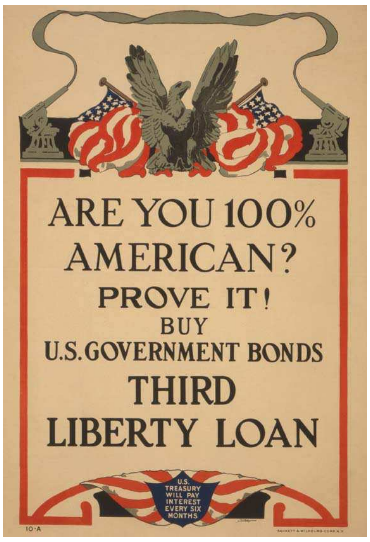
When I first told an Italian friend that I was planning to write a history of public debt, he rummaged around in the attic and gave me a faded postcard, which is reproduced on the screen. It is an advertisement for a public loan during the First World War. I looked at it, smiled at the bombastic pose, and put it away, little thinking that it had much relevance for my researches, which in those days were largely centred on creating databases of government financial statistics as far back as I could manage. I certainly do not regret that labour, since it is not possible to understand the history of public debt without such information.

However, as I went on, I realised that the economics was incomprehensible except in combination with politics. I took out the photo again and started to think about its implications. I knew that the First World War, perhaps more than any other in history, had been financed almost exclusively by borrowing – hence the need for this postcard. It looks rather like the famous poster of Lord Kitchener pointing the finger of duty at passers-by, urging them to enlist. But this Italian poster is not seeking out solders, but lenders. To whom was it addressed? Obviously not to a roomful of international bankers, whose response, or rather lack of response, can easily be imagined. The war loan posters of the World Wars are always addressed to citizens, and, like this Italian one, they consistently present lending to the state as a duty of citizenship. Here are a couple of examples from America in which the connection is relentlessly hammered home.



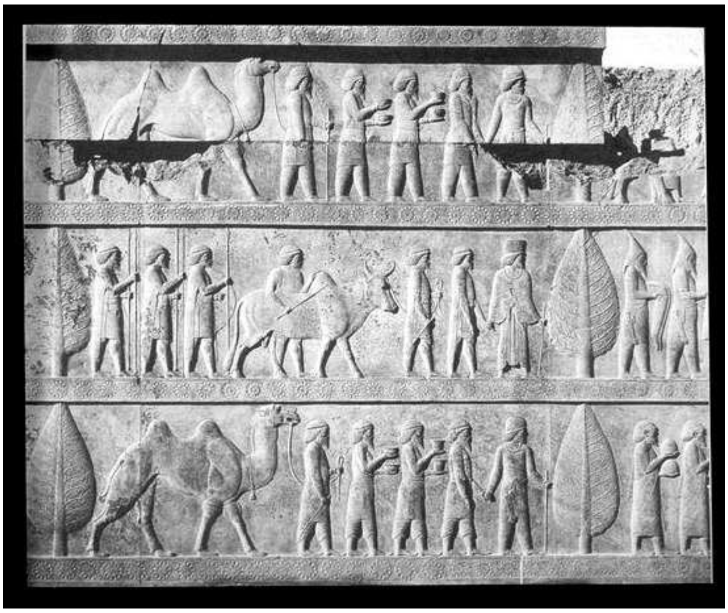
The idea of the citizen creditor started to form in my mind as a parallel to the citizen soldier. The citizen soldier fights to defend his country as a corollary of his citizenship. He is not a mercenary – a soldier who fights merely for money. The citizen creditor lends to his country because lending is also a corollary of citizenship. He is not a mere rentier – a coupon clipper; nor an international banker – the financial equivalent of a mercenary. The close connection between the citizen soldier and the citizen creditor is shown by the fact that the war loan posters consistently portray fighting and lending as morally and politically equivalent. Here are two representative examples, this time from the Second World War, out of a huge number that I have come across.

The question is: why is this important? Perhaps the citizen creditor was merely a convenient propaganda construct of financially desperate governments in the world wars. I hope to show that nothing could be further from the truth. The citizen creditor has played a crucial role in one of the most significant developments in world history – the rise of democracy.

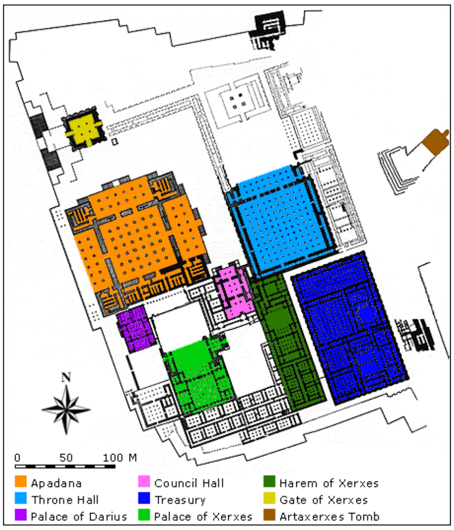
Nowadays, the fact that the most advanced and powerful nations of the world are democratic is taken increasingly for granted. Yet historically it is a strange phenomenon. For most of history, the most advanced and powerful states were autocratic, not democratic. A powerful reason for this was public finance – and more particularly war finance. One of the few constant features of public finance is the difficulty that states find in raising taxes rapidly. Even the taxes that people are accustomed to pay are widely disliked, but they are far more readily accepted than tax increases, or, even worse, than new taxes.
The classic solution to this problem was the war chest. The state would depend on running a budget surplus in peacetime to fill up its treasury, so that there would be ample funds available for the next war. States with the greatest ability to accumulate had an inherent advantage in the struggle for survival. And it was the great autocratic empires of antiquity that displayed the most conspicuous capacity to store up surpluses – for two reasons. In the first place, they were able to tax their subjects at will, and secondly, they were able to concentrate the rewards of conquest in the hands of the ruler.

Perhaps the best example of this system is the Persian empire. If the Greeks are to be believed, the Persian treasury contained the equivalent of nearly 450 tons of gold when Alexander the Great captured it. That would equate to around $9 billion at current gold prices. But even that may not give a true sense of its value at the time. The Persian empire had a population that has been estimated at between 15-20 million living almost entirely on subsistence agriculture. The treasure would probably have represented a very large portion of the GDP of the empire. To put things in some sort of perspective, present day Syria – which has a comparable population to the old Persian Empire, but a far more advanced economy – has a GDP of $25 billion. Present day Mozambique – again with a comparable sized population, but based almost entirely on subsistence agriculture – has a GDP of only $6 billion.

Here are some pictures of Persepolis that serve to illustrate the financial nature of imperial rule.



The main decorative feature of Persepolis is the monumental stone reliefs showing tribute bearers arriving from every part of the empire. The tribute they brought was stored in the vast treasury, measuring around 10,000 square meters, that formed a central part of the Great King's palace.



Persepolis – the treasury is bottom left

The central feature of the Persian fiscal system was the collection and accumulation of treasure.

It doesn't take much to see the defect in this system of public finance. Precious metals were not only rare, they were also expensive to mine, and, crucially, they constituted the money supply. And yet states regularly buried large parts of these hard-earned assets underground in a process that was tantamount to mining in reverse.

It is, therefore, not hard to see the advantages of public borrowing – a system that permits these hard-earned assets to circulate in the economy to be tapped only as needed.

But where was the idea of public borrowing to come from? Certainly not from the great empires. Why would a pharaoh, a god in human form, with the power to compel his subjects to build veritable mountains of stone to house his mortal remains, think of borrowing? Whatever he needed was his by right.

Yet the 'imperial' model was not the only system of public finance in the ancient world. The tribal societies that surrounded the great empires operated on completely different principles. In tribal societies all able bodied males had the automatic obligation to take part in the defence of the community. And not only defence, for many of these societies were quite aggressive. A common feature of tribal life was raiding one's neighbours for livestock, and sometimes for wives. At the end of the raid the booty would be divided up between the tribesmen. There was no central treasure chest, no taxation, and no state.

The issue of taxation is central. Nowadays people have become so used to paying direct taxes (if somewhat reluctantly) that it is hard to understand just how offensive the idea seemed to people who considered themselves free in earlier times. Taxes were paid only by the unfree – those who had either been conquered, or whose indigenous rulers had arrogated such power to themselves that the once-free tribesmen had been reduced to the status of subjects. Herodotus put the ancient Greek view of the matter succinctly when he tells us that "Croesus was the first non-Greek that we know to have subjected Greeks to the payment of tribute... Before Croesus's reign, all Greeks were free."

I think that it is easy to see that, whatever advantage they might enjoy in political freedom, such free societies would be at a considerable disadvantage in a world that depended on the amassing of treasure. The treasure chests of the empires were filled by running a budget surplus in peacetime, and by the accumulation of windfalls such as the spoils of war. A society that rejected the taxation of citizens as politically offensive and that distributed windfalls among the people was unlikely to build up much treasure.

It is not hard to see tribal warriors, owing military service as an part of their membership of the tribe, as the prototype of the citizen soldier. To my mind, they were also the prototype of the citizen creditor. On the one hand there is the contribution of manpower to the communal cause, and on the other hand there is the repayment at the end of the endeavour by participation in the spoils.

But how is one to get from these simple tribal customs to the sophistication of modern bond markets?

The best way to see the link is in ancient Rome – the Rome of the early republic, not of the empire. It is often lamented that in the modern world, status and money seem to go hand in hand. However, I can assure you that this is in no way purely a modern phenomenon. Everything in the Roman constitution was tied to money. All citizens had their wealth assessed, and this assessment determined not only how much financial contribution each citizen was expected to make in wartime, but also what rank he would hold in the army, and therefore what percentage of the spoils of war he was entitled to. No one has so far thought to see in this system a connection with the idea of public borrowing, but to my mind the connection is clear.

The Romans edged a few steps closer to modern financial practice during the Punic Wars. The Romans were great soldiers, but they were not great sailors. However, if they were going to beat the Carthaginians, they would have to build a navy. Their poor nautical skills were displayed when they allowed the whole fleet to be destroyed by a storm that the Carthaginians shrewdly avoided. Another fleet was built, this time financed by voluntary contributions from wealthy citizens. It was agreed that these contributions would be repaid out of the spoils of victory – assuming, of course, that there were any.

Equally important was the way that the Roman treated taxes. Like the ancient Greeks, the Romans did not like direct taxation of the citizens. But given the extreme danger in which they were placed by Hannibal, they could not avoid the idea, and many special war taxes were levied.

However, when the war was won, and Rome went on to conquer the wealthy eastern Mediterranean, they repaid all the Punic War taxes out of the booty from their eastern campaigns. In both these cases distributions to the citizens were specifically tied to financial contributions.

So, the Romans showed how the primitive division of the spoils might evolve into a system of public borrowing. But their loans (if we can call them that) had two features that separate them sharply from modern public debts. First, they were interest free. Second, they were only a contingent liability of the city – contingent, that is, on military success. Their management would have caused few of the sleepless nights that beset modern ministers of finance.

The Roman experiments in public finance did not go any further. Once they became an imperial power, the Romans had no need to raise money from the citizens. Like all empires before them, they lived off the taxation of their subjects and the accumulation of a treasury to cope with financial emergencies. The imperial model of finance had once again triumphed – and the "republican" model (if one can call it that) appeared to be no more than an historical curiosity.

But history has a way of refusing to lie down and die. The great empires were not invulnerable. Occasionally, the primitive tribes beyond the frontiers could form into coalitions large enough to topple the mightiest of them. More often than not, this made little difference to the sweep of history, for the tribal conquerors soon became imperial themselves. Look, for example, at what happened in the seventh century AD. The Arab conquest of the Middle East was so stunningly fast that while it overturned the existing imperial order, it did not destroy it. Within a generation, the plundering hordes of Arabs on camels had turned into a classic tax-gathering empire, little different, financially, from the Sassanian Persians or the Romans before them.

But the Dark Ages of western Europe were different. The process of invasion was agonizingly prolonged and brought with it a strong degree of economic retrogression – money, for instance, almost completely disappeared. Every time some sort of order seemed to re-established, a new wave of barbarians appeared on the scene, and the process did not finally come to an end until around 1000 AD when the last of the tribal invaders, the Vikings and the Magyars, finally settled down and converted to Christianity. By then the chance of establishing strong states on the old imperial model had long since disappeared.

There were two vital consequences of the long period of barbarian invasions in Europe. One was political fragmentation, allowing a large number of competing small states to emerge with ample room for experimentation. The other was the collapse of taxation. Even when unified kingdoms started to re-emerge, their kings had almost no financial resources when compared to the empires of the ancient world, or to those of medieval Asia.

This was how Italy once again became populated by city-states. And it was in the great medieval Italian republics, particularly Venice, Genoa and Florence, that public borrowing was turned into a system.

Like all people who considered themselves to be free, the citizens of the Italian republics wished to avoid the indignity of direct taxation. Yet, like others before them, they needed to find a solution to the problem of emergency finance.

There was, however, one major difference between the citizens of medieval Venice and the citizens of ancient Athens or Rome. They were merchants, not farmer-warriors, and they had, therefore, an instinctive gift for putting their public finances on a commercially viable footing.

The way in which they managed to do so is fascinating. They took up a technique that had been used by the Roman Republic in the Punic Wars – repayable taxation. Whether it is pure coincidence that this distinctive idea flourished in Italy in two periods separated by over one thousand years of history is impossible to say. Like the Romans, the medieval Italians levied money from the citizens according to an assessment of their wealth, on the understanding that the money would be repaid as and when the city was in a position to do so. The crucial invention of the Italians, however, was to pay a fixed and regular interest on the levies until they were repaid. The money to pay the interest was to come from customs duties and excise tolls – in other words from indirect taxes which the Italians – like the ancient Greeks – felt to be less insulting to their sense of personal freedom.

The addition of regular interest payments to the loan was a crucial breakthrough. For suddenly the levies became attractive to other investors. After all, who would want to buy a loan with no current interest as well as no certain date of repayment? A trading market now started up in which citizens who were short of cash could sell their loans to those who had surplus cash on hand. The Venetians had, perhaps unknowingly, invented the bond market.

This was truly a revolutionary moment in the history of the world. The Italians had taken the primitive tribal practice of distribution of surpluses and turned it into a viable alternative form of public finance – for the first time there was a real challenge to the principle of the treasure chest. Let us look at how and why the system worked so well.

First of all, the debt was long-term. If any great amount of public debt was to be raised it had to be long-term so that the cities did not find themselves in a cash bind as loans fell due. The fact that the levies were only repayable at the option of the city solved that problem.

A second ingredient was a low level of interest. Again, the same principle applies. If any great amount of public debt was to be raised it had to be cheap.

The parallel is with the difference between mortgage debt and credit-card debt. A bank will typically grant a customer a long-term mortgage at a fixed, low rate of interest up to, say, four times his income. But his credit card limit will be a small fraction of that amount.

Venice led the way in making interest affordable by making 5% the standard rate on all its loans – a rate, one has to say, that seems impressively low even now, but particularly so for the period. Interest rates in Sung China, the most advanced civilization of that time, were over 30% per year.

Initially the rate of 5% must have been below the market. But as the city developed a track record of prompt payment of interest the loans became increasingly attractive. By the middle of the fourteenth century prices had risen to the point where they were selling at slightly above their face value.

But if the debt had to be long-term so that it was affordable for the city, how was it to be affordable for the citizens? This was where the bond market came in. Don't forget that the citizens had no choice whether to subscribe to loans or not – it was their obligation as citizens to do so, whether they had the cash on hand or not. Moreover, the Venetians were merchants who would experience wide fluctuations in cash flow depending on whether their ships were at sea or had come home. The bond market meant that citizens with surplus cash to invest could buy the loans of those whose ships were still at sea. The bond market performed a miracle by making a loan that appeared long-term to the borrower appear short-term to the lender.

But there was a further advantage. The treasure chests of the empires withdrew money from circulation. But the Italian cities had no treasure chests – all they had was debts. The money was left circulating in the economy. Moreover, the invention of the bond market meant that even the debts of the cities became an additional form of money – not useful, obviously, for going down to the market and buying small items like food, but certainly useful for buying big-ticket items like houses or ships or cargoes.

The invention of the Italian cities was so profound that it had implications that went beyond the cities themselves. It could not be ignored by kings. And it is here that the second result of the Dark Ages comes into play – the kings of Europe were perpetually short of money, for they had largely lost the power to tax. They rarely had more than very modest amounts in their treasure chests – certainly nothing that could compete with the empires of old. The new credit markets were a tempting way to solve their financial difficulties.

Why could the kings not simply copy the Italian system, and therefore resolve their lack of treasure by this new system of finance?

Here we enter the question of the connection between public borrowing and democracy – and to the historical role of the citizen creditor.

There was a secret to the success of the Italian system that the kings could not copy. If ever there was a time and place in history that most perfectly encapsulated the idea of the citizen creditor, it was the city-states of medieval Italy. To be a citizen of an Italian city-state meant to be its creditor. The state was in permanent debt to its citizens – it was a relationship that perfectly symbolized the fact that it was the citizens that controlled the state, not the other way around. In Genoa, one of the wealthiest cities in Europe, there was a saying “The Genoese are rich but the republic is poor.” And because the citizens controlled the state, they were in effect lending to themselves.

This was crucial to low interest rates that made the system possible.

In every interest rate there is a premium for risk. This is made up of two components: an element of external risk – to do with things that are beyond the control of the borrower; and an element of moral risk – is the borrower trustworthy ? The element of moral risk is especially important when lending to a government – for there are no effective legal constraints to force the state to fulfil its obligations.

Because the Italian cities and their creditors were symbiotic, they were, in effect, lending to themselves, and the question of trust never arose.

The kings could never compete, even if they wished to. There was no symbiosis of borrowers and lenders. Kings tended to see their creditors as a bunch of profiteers who were out to fleece them. The result was that they inevitably paid higher interest rates than the cities, and this in turn increased the likelihood of default.

But quite often the kings were happy to default, so that that they could squeeze out some of the excess profits from their lenders. They operated what was, in effect, a system of debt management by bankruptcy.
The virtuous circle of the cities was replaced by a vicious circle.

The revolution in public finance made by the Italian cities had truly revolutionary consequences. It overturned the long-term financial advantage of autocracy, and gave political freedom a new weapon. Adapted and improved by the Dutch Republic, it enabled the Dutch to take on the might of the Spanish Empire and win their independence.

But as long as the financial system was confined to small city-states – or even to leagues of cities like the Dutch Republic – the monarchies had little reason to worry. They could continue to dream of achieving absolute power, and of raising sufficient taxes that they could escape for once and for all from the need to borrow.

But all that was changed after 1688, when a sizeable monarchy, England, established a parliamentary system of government that allowed it to adopt the financial system of the mercantile republics, and therefore enabled it to challenge France, the largest and most successful of the absolute monarchies.

The French Revolution was undoubtedly the climactic event of the eighteenth century. However, the origins of this great event have often been misunderstood. The Revolution was not set off by the sudden uprising of downtrodden people, as so vividly suggested by the annual commemoration of Bastille Day. It was the direct result of the bankruptcy of the ancien régime in August 1788. The French monarchy had defaulted on its debts on many previous occasions – in fact it had an unenviable record, reaching back into the Middle Ages, of defaulting after every major war. But this time was different. The bankruptcy of 1788 was not only financial, in the obvious sense that the government was unable to pay its bills, but also political. The rulers of France recognized that their autocratic state could no longer compete financially with its arch-rival Great Britain without major political reform.

And yet, this was an astonishing state of affairs. Nowadays the populations and GNPs of France and Britain are more or less identical. But in the eighteenth century France had a population that was three times as large as Britain's. It should therefore have had a significant advantage not just in manpower but in terms of money. Yet this advantage was outweighed by Britain's ability to borrow massive sums cheaply.

How could this be so? The answer was contained in a warning by a high ranking French official in 1774: "If people believe [the king] to be a despot it will be impossible to open loans, or, if that route is taken, they will be so costly that England will always finish by having the last *écu* in any war." In other words, in Britain, with its elected government, there was a far greater degree of trust between the state and its creditors than in France with its unelected autocrat.

As early as 1715, the Duc de Saint-Simon had put his finger on the fundamental reason why France could not compete. In a world of public borrowing, success depended on public trust in the system, and this was only possible "in a republic, or in a monarchy like England, whose finances are controlled by those alone who furnish them." In other words, Saint-Simon pointed to the citizen creditor as the crucial element in the system.

A few simple facts tell the tale. In the sixty years of Anglo-French warfare before the Revolution, Britain borrowed almost twice as much as France. Yet because of its better creditworthiness, Britain's borrowing cost was only half as high. Perhaps the most astonishing demonstration of the difference in credit standings is that by 1788 Britain's national debt represented almost 200% of GNP, and yet the country was still comfortably solvent, whereas France, with a debt that represented less than 70% of GNP, was insolvent.

The dire state of French finances in 1788 was the lever by which the doors of absolutism were broken down. It was the financial crisis of August that finally forced the king to summon the Estates General, the ancient parliament of France which the Bourbons believed that they had consigned to the dustbin of history in 1614. This is why Mirabeau, the most important figure in the National Assembly from 1789 until his death in 1791, proclaimed "Gentlemen, I have no fear of repeating it. It is the public debt that is the germ of our liberty."

The French Revolution and the Napoleonic Wars produced a clear winner in a contest between financial systems. For all its military successes, France was unable to compete financially with Great Britain, largely because it was unwilling and unable to borrow. The Revolution lived off a diet of paper money and confiscations. The Napoleonic empire lived off moderate taxes at home and the spoils of conquest abroad. Britain continued to outspend both regimes as effectively as it had outspent the Bourbon kings. After 1815 it seemed clear that the only way to run public finances successfully was a combination of parliamentary government and public borrowing, backed up by a bond market.

But nonetheless, there was an unresolved issue. You may remember that it was ancient Rome that I chose to illustrate the transition from the primitive division of the spoils to structured public borrowing. It was not Athens – and therein lies a tale.

The ancient Athenians displayed all the principle characteristics of "tribal" finance. First, they rejected direct taxation, and chose instead to donate their money to the city freely, as a demonstration of their political freedom and of their public spiritedness. Second, the Athenians favoured distribution of financial surpluses among the citizens. But what the Athenians did *not* do was to tie the amounts contributed by the citizens to the state to their participation in the distribution of surpluses. And the reason for this was the populist nature of Athenian politics. The demos preferred a system in which the poorer citizens received more than they contributed.

When borrowing was turned into a true system of public finance in medieval Italy, it meant that citizens started to have permanent claims on their governments. But inevitably it was the wealthy who held most of these claims. This was unavoidable in a system that depended on the operation of a free bond market that could tap liquid wealth where it was to be found.

Such a system might be politically stable when the right to vote was restricted to those with property. In Britain, to give an example, there were 300,000 public creditors by the end of the Napoleonic Wars. Now in one sense this was an impressive number – far the highest number of bondholders so far in the history of the world. And it was also a substantial majority of the electorate which numbered around 400,000. But it was a small number as compared to the adult make population of the country at the time, which was over 4 million – all of whom would receive the vote if the country moved toward universal suffrage.

The new voters might well reject the system of interest bearing public debt, and prefer paper currency inflation – as had the French and American revolutionaries. But hyperinflation is not a viable system of public finance except for very short periods. Both the American and French experiments imploded within a few years.

How was the circle to be squared?

There was, perhaps, no way to make the problem disappear entirely. But there was one obvious solution: to ensure that as large a part as possible of the new voters became public creditors. This would give as many people as possible a financial stake in the system.

The first way to do this was the public savings system, pioneered in Britain in the aftermath of the Napoleonic War. Small savers were encouraged to deposit money in government backed institutions that invested in the public debt. The results were spectacular, especially after the Post Office started offering savings accounts in 1860. By the beginning of the 20th century there were 10 million accounts in the British system – the equivalent of one for each household in the country.

This system of postal savings favoured slow accumulation in peacetime. A more direct approach was developed in France during the Crimean War. Mass patriotic bond drives sold government bonds in small denominations directly to the public. This system was successfully copied shortly afterwards in America during the Civil War.

Public savings systems and popular bond drives not only gave the newly enfranchised masses a stake in the solvency of their governments. Just as significantly, a new bond between government and citizens had been formed, in which the government took moral responsibility for the savings of the unsophisticated – protecting them from fraudulent investment schemes.

The clearest evidence for the success of the system is to be seen in the almost universal fall of interest rates in the decades before the First World War in tandem with the move to universal male suffrage. It was also visible in the absence of revolution in precisely those advanced countries where Marxist doctrine suggested that it should first break out – to the point where Marx started to despair. He castigated public savings systems as "a golden chain on which the government holds a large part of the working class"

The First World War represents perhaps the high point of what I call the "democratic" system of war finance. Its strengths by now seemed so far beyond dispute that all the combatants attempted to employ mass bond drives as the main vehicle of war finance – even Russia. The wartime bond drives collected massive enormous numbers of subscriptions. In Britain, France and Germany up to 7 or 8 million citizens responded to the governments' appeals. In the USA the figure was over 22 million. By the end of the war, there were few households in any of the combatant countries that did not own government bonds.

In the Second World War, the western democracies again financed the majority of their war efforts by borrowing. Once again citizens lend vast sums to their government at vanishingly low interest rates.

But significantly, the system was not universal this time. The democracies were not copied by the totalitarian states. In part this is explained by the fact that both Russia and Germany now had an unenviable track record as borrowers. Russia had repudiated its debts during the Bolshevik revolution, while Germany had inflated its debts away in the hyperinflation of the early 1920s.

Yet, this is not the whole story. Hitler, at least, was in a position to blame the fate of the German debt on the weakness and irresponsibility of the despised Weimar Republic. But Hitler also understood a crucial aspect of war loans: they acted as financial referendums on the conduct of the war. Governments had to have courage to use them. A popular anti-war movement that chose to target bond drives would have dealt a massive blow to the prosecution of the war.

So Hitler never used bond drives – in spite of the fact that they would seem to have well suited the regime that brought us the Nuremberg rallies. But Hitler was no fool. He understood that bond drives gave the population the chance to vote – with their wallets. And voting was something that Hitler wished to avoid at all costs.

I think that, precisely because of their role as running referendums, the bond drives of the two world wars represented a high point in the history of democracy.

However, I think that there are reasons to believe that the Second World War marked the swansong of the citizen creditor as we have come to recognise him. Nowadays the political and financial landscape has changed. The bond market has become a depersonalised business with virtually no popular participation.

I can think of several reasons for this. For one thing there is the changing nature of financial markets.

- First, there is the ever increasing role of institutions. Domestic and foreign institutions now hold the vast majority of government debts in all western countries.
- And then there is the increasing sophistication and speed of the financial markets. Governments can raise huge sums almost instantly and at very little cost.
- The result is that governments can scarcely be bothered to deal with the expense of dealing directly with a large number of small lenders, even if they are their citizens.
- The UK, I would have to say, is to some extent the modest exception that proves the rule. National Savings still provide close to 20% of the public debt, whereas the Savings Bonds, which are the US equivalent, represent no more than 5% of the US debt. Elsewhere the figures for popular participation are even lower.

Of course people have an indirect stake in the public debts of their countries - but few people seem to know or care.

And then there is the changing nature of warfare. Mass bond drives were needed to finance the huge levels of spending required for two World Wars. But the invention of the atomic bomb changed everything. It is not just that a nuclear war would be over in a flash, as it were. It is also that nuclear weapons have made superpower wars inconceivable. The only wars nowadays are limited local campaigns that require historically tiny amounts of money.
During the Second World War the combatants spent sums annually equivalent to 50% of GDP. The Iraq war has cost barely 1%.

And finally, there is the changing nature of borrowing.

There may have been no major wars since 1945, but that does not mean that there has been no public borrowing – far from it. But peacetime borrowing is completely unlike wartime borrowing. Peacetime deficits are the result either of Keynesian counter-cyclical spending in an economic downturn, or of socio-political stalemates about levels of taxation and spending. It is ludicrous to imagine waving the patriotic banner to finance deficits with causes such as these.

With the disappearance or war finance as the main financial connection between the state and its citizens, the state has been left with its secondary role of guardian of the savings of the less wealthy. This remains the underlying purpose of National Savings in the UK. However, even national savings systems have been reduced to insignificance by the development since the 1940s of a quite different kind of state-run savings – namely, state pensions.

I think that the virtual disappearance of the citizen creditor from the financing of public debt is closely related to his reappearance in somewhat altered dress as a state pensioner.

State pensions embody the fundamental, primeval characteristic of public debt – a process of contribution and subsequent repayment involving the whole citizen body. From a purely political point of view state pensions display these characteristics almost better than conventional public debt. All citizens are involved, and their financial relationship with the state is direct – not intermediated by financial institutions.

In the aftermath of the war, interest payments on the vast post-war debt were more than double payments of state pensions that were then still in their infancy. By 1962 the figures were more or less equal; and now payments of state pensions are double payments of interest on the national debt. They are no less than ten times greater than payments of National Savings.

No wonder that state pensions have become the prime financial relationship between citizens and state. And no wonder that people are no longer aware of the one-time political importance of conventional public debt.

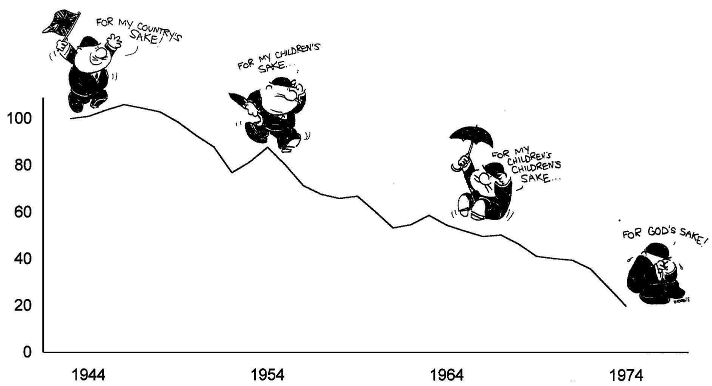
What is the significance of these changes? The answer is that it is difficult to know without being a clairvoyant, which I am certainly not. So I will limit myself to a couple of observations.

First, state pensions are inherently different from conventional public debt. As we have seen, conventional public debt requires that amounts repaid are strictly related to amounts contributed. This is what makes a bond market possible. And, historically, it was the flexibility provided by the bond market that turned public debt into a potent vehicle of national power.

In state pensions, by contrast, there is no strict connection between contributions and distributions. This reflects the fact that they have little or nothing to do with war finance, and a great deal more to do with redistribution of income in society. It might be said that their distant ancestor is ancient Athens rather than medieval Venice.

My second thought is about what happens if there was to be a conflict between state pensions and the conventional public debt. This is not an abstract issue, since the affordability of existing pension arrangements is becoming a political hot potato in most western countries. In legal theory it is the conventional debt that should take priority. But in a situation in which citizens no longer identify their financial interests with the conventional public debt, it is not quite so clear what would happen. There is always the possibility that governments might choose to inflate away their official debts while continuing to protect state pensions. This is what happened in the inflation of the 1960s and 70s.

I can't help reproducing this cartoon from the 1970s that laments the fate of the British patriotic bondholder after the world wars.



The Rewards of Victory

The Price of British 3.5% War Loan 1944-1974

The question is: Why was the poor citizen creditor ignored in the post-war era? And why did his abandonment not lead to worse political consequences? I would argue that the citizen creditor could be safely abandoned partly because his old role as war financier had become redundant. But meanwhile, he did not kick up too much fuss because he had been reincarnated as a state pensioner, and as such his financial position was protected.

But what if governments were to choose to follow the letter of the law, and give their conventional debts precedence, even if it means reneging on pension commitments? Perhaps they would be wise to look at the history of the Weimar Republic. In the aftermath of the mass bond drives of the First World War, German households held large parts of their financial savings in the form of government bonds. Their savings, however, were wiped out by the hyperinflation of the early 1920s. This debt jubilee may have liberated the state from a burden which it was ill able to afford, but it did so at the cost of undermining support for democracy among those who should have been its most natural supporters – and thereby paving the way for the rise of Nazism.

I think perhaps that the main message is that the citizen creditor – in whatever guise he may appear – is integral to democracy. He is tampered with at peril.