

THE HISTORY OF GOVERNMENT DEBT JUSTIFICATION

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Abstract

The objective of the paper is to study the evolution of attitudes toward government debt over the period of human history from the Middle Ages to present day. This article is especially relevant in light of recent events. The skyrocketing government debt has recently led to the lowering of credit ratings in the USA, Greece and Italy, which may cause a significant economic downturn. To reach the established objective, the following research methods were employed: comparative analysis and synthesis, historical and logical approaches, observation and aggregation. As a result of conducted research, the history of the national debt justification was divided into five basic stages. The authors critically analyze the theory of capital erosion and demand-side economics. Detailed study of the first four stages showed that attitudes toward public debt evolved from total rejection to approval and all-round justification. However, global financial crisis indicates the transfer to the fifth stage, in which sovereign debts require reasonable restrictions and international regulation.

Keywords: government debt, erosion of capital, demand-side economics, financial crisis.

JEL Classification: H63, F34, H12, H20, H50, B10, B20.

Introduction

Historically, the main sources of financing government expenditures have been: taxes, revenues from property, seigniorage and borrowings. The most problematic and widely discussed of them today is government debt. *The objective* of this paper is to study the evolution of scientific views on state borrowings over the period of human history from the Middle Ages to present day.

The world financial crisis, which began in 2008, forced governments to increase their debts in order to support the private sector and stabilize the economic environment. The amount of government debts in many countries rose so significantly that nowadays it can be compared to the size of their gross domestic product. It is obvious that even developed countries cannot ensure the incredibly high revenues that would be required to repay such large government debts. For example, in 2011, due to the fact that general government gross debt in percent of GDP in the USA, Italy and Greece reached 100%, 121% and 166%, respectively, the solvency risk of these countries increased substantially and their credit ratings were lowered (International Monetary Fund, 2011). Other countries also suffer from significant debt burden. This situation has put additional obstacles in the way of global economic recovery.

The research problem of this paper is to find out how the government debt of many countries has reached such an enormously high level and what authorities should do to avoid this situation in the future. The authors examined different sources of scientific literature and statistical data, which concern public debt. To reach the established objective, the following *research methods* were employed: comparative analysis and synthesis, historical and logical approaches, observation and aggregation. Most scientists usually concentrate on studying of particular historic periods or certain economic theories. *The novelty* of this paper consists in broaden view on the topic, which enabled to reveal five common stages of evolution in attitudes toward government debt in different countries over the period of human history.

The first stage: condemnation of debts

During the first stage, which lasted from the Middle Ages until the end of 17th century, government debts were considered to be inadmissible. This can be explained by the prevalence of the traditional economic system in this period. Subsistence economy supposes that the nation should produce all the necessary goods for existence on its own and consume them virtually without any surplus. Practically all people were engaged in agriculture. According to a farmer's worldview, a good head of the household or of the country should be able to reserve resources for difficult times and spend them thriftily. Thus, the appearance of the government debt was regarded as a sign of inability to administer the affairs of state and a display of excessive wastefulness. This outlook forced the heads of state to go to extremes to avoid debts.

Thus, King Richard II of England used threats of total ruin in order to compel men of substance to draw promissory notes, which he then used for his own needs. In Russia, Tsar Ivan IV ordered citizens of the

Vologodskaya region to deliver a parcel of Lebanon cedars to Moscow, and citizens of Moscow to catch a hat full of live fleas. Fines were imposed in case of failure to comply with his commands. (Bogolepov, 1910)

In France, during the reign of Louis XIV, different public positions were established and sold on a mass scale in order to replenish the state treasury. Voltaire (1779) left behind a list of those positions; beside ordinary police, judicial and financial positions, there were wig inspectors, stone measurers, hay counters, visiting inspectors of pigs and piglets. There were also King's counselor-supervisors of firewood stacking (*conseillers du roi contrôleurs aux empilements de bois*), butter freshness overseers (*visiteurs du beurre frais*) and officials responsible for tasting salted butter (*essayers du beurre salé*). However, this practice only increased state debt, as all the proceeds were spent on officials' salary.

To make up the budget deficit, some European rulers not only increased taxes, but also conducted coinage debasement (Spufford, 1988), which was criticized by contemporaries as a cause of inflation. For instance, Nicolaus Copernicus (2010) considered coinage debasement as one of the main reasons for the downfall of nations. Also Rent was a significant source of state revenues that acted as an alternative to government debt in the Middle Ages. It can be referred to as a kind of state borrowings pledged by property, because in exchange for the right to use land, public authorities received annual income (Fryde, 1963). However, government rent contracts resemble leases much more than they do loans.

Besides the condemnation of debt caused by the dominance of subsistence farming values, theology and scholasticism also played a huge role in hampering credit relations development. The Church condemned borrowings on the basis of Christ's words: "lend expecting nothing in return" (Gospel of Luke, 6:35). Thus, usury considered to be a great sin because it was transaction that obliged a debtor to pay back both principal and interest and gave a creditor the right to demand the fulfillment of commitments. As we know, religion and politics were inseparable for a long time in human history. So, "the struggle against usury was energetically and ruthlessly conducted by Church, towns and princes" (Bigwood, 1921).

Scholars censure debts in terms of Aristotelian natural law and the inherent sterility of money, which state that it is unnatural to gain money out of money and the borrower should repay exactly the same principal sum which he was lent. According to scholasticism, if a creditor receives interest, it means that he is robbing the borrower by depriving him of his capital and making the gained money sterile, unable to be used by the borrower in his industry (Noonan, 1957). It is obvious that credit becomes economically pointless if it does not bring any profit. Thus, bans on usury put significant obstacles on the path of development of financial systems which could provide the public sector with necessary credits at low rates.

The first interest bearing public borrowings secured by future tax incomes appeared in Italian cities in the 12th century (Hocquet, 1995). Nevertheless, relationships between lenders and the government were maintained under duress. Citizens were obliged to bring forward definite sums of money at an established date. In return, they received credit payments. That system of forced loans looked more like tax burden than urban borrowings for two reasons: because it can be considered as partly repayable taxes and because there were cases when the government didn't keep its commitments. For example, this was the case in Venice and Florence in the 14th century as their expenditures increased during war. So, since the times when government debts began to appear, we can observe government defaults as well.

The Age of Discovery (15-17 centuries) contributed to the development of world market, branches of industries and also to changes in people's outlooks. In the early sixteenth century Venice, emerged the first government voluntary loans, which supposed that citizens could choose whether or not they want to invest money in the state. The amount of this kind of government debts gradually increased in many other European countries (Pezzolo, 2003). The Middle Ages were replaced by the Renaissance and a new stage of evolution in attitude toward government debt began.

The second stage: government debt justification in case of emergency

During the second stage (the end of the 17th until the beginning of the 19th century), government debt gained justification in the event of emergency like war or natural disaster. This stage was triggered by three main causes:

- the development of market economies and banking system;
- the separation of powers into three branches: executive, legislative and judiciary;
- the compartmentalization of the State Treasury from the King's Treasury, which resulted in a limitation of opportunities for rulers to use public income at their own discretion.

Thus, government debt was explained by the necessity to create general welfare and was connected with social needs, such as financing wars in order to win, but not with the ruler's wastefulness. The changes

during the second stage, which are referred to as the Financial Revolution, happened first in financial system of the United Kingdom and then in other European countries.

At the end of the 17th century, the policy of colonization and the beginning of war with France (which lasted for half a century) led to the depletion of state budget. It was not possible to raise taxes to higher rates, so, for the first time, the government borrowed money from the Bank of England, the original license of which was issued in 1694 by Act of Parliament. Government debts became not just municipal or personal obligations, but national ones that were freely negotiable all over the world. This increased confidence that commitments would be fulfilled.

During this stage, economic science tried to generalize the positive and negative effects of government borrowings. From our point of view, the opinions of different economists were summarized best by Ferdinand Wurst (1808), an honorary member of the Russian Academy of Sciences. According to his studies, advantages were seen in the fact that government debts increase the property of a nation, facilitate money circulation, help to avoid coinage debasement, disseminate and multiply foreign trade and increase trade profits of a nation. The disadvantages of government debt at that time were: a population increase in the capital; the exclusion of gold and silver from the circulation sphere; tax increases; the lazy and inactive lifestyle of the state's creditors; the possibility that the state would transform into a tributary of foreigners (Wurst, 1808).

The last shortcoming of increasing government debt mentioned in the list is still under active discussion. Nowadays, it is called the risk of sovereignty loss. For example, Greece has enormously high debt in comparison to its GDP. The European Union saved this country from default "by agreeing to release the next tranche of aid, but Athens will pay with a massive loss of its sovereignty" (Mahony, 2011). To be able to repay its debt, Greece "will have to push through a swathe of privatizations", as it "agreed to raise €50 billion by 2015 through a massive sell-off of state assets" (Mahony, 2011). The European Commission controls all political and economic actions of Greece to be sure that Athens will carry out its commitments.

What is more, Frank Schaffler, a German politician, advised "bankrupt Greeks" to "sell islands... and sell the Acropolis too!" Then, Arturas Zuokas, the mayor of Vilnius, made an offer to Greece to acquire an island as "an exclusive place for rest in the Mediterranean" and "a great global advert for Lithuania", featuring a spa, museums and a theatre (The Economist, 2011).

The state trade of land for money was common in the 19th century and it may be resumed again, as countries other than Greece, including Italy, Ireland and Portugal, also have huge debts. Some territories of these countries probably will be sold as Louisiana was by France to the USA in 1803, as Alaska was by Russia to America in 1867 or as the Caroline Islands were by Spain to Germany in 1899.

The third stage: new arguments in favor of government debt are weakened by the theory of capital erosion

During the third stage (middle 19th – early 20th centuries), owing to the extension of state involvement in development of national economy and the expansion of the government's role as a creditor, government debt obtained an essential amount of supporters. Thus, opponents of government debt faced sufficiently strong opposition. For example, some believed that government debts shift current financial problems to future generations. Such behavior was considered very unfair because descendants should not pay debts which were made by their predecessors. British Prime Minister Benjamin Disraeli in particular insisted in his speech to the House of Commons on March 6, 1862 that it is wrong to think "that posterity is a pack-horse, always ready to be loaded."

However, different scientists of the 19th century disputed this assertion. For instance, Karl Rau, one of the leading financial theorists of the time, pointed out that transfer of debts does not violate justice. Quite the contrary, descendants must pay for all of the material benefits that they have inherited from previous generations (Rau, 1868). Russian economist Edmund Vreden (1835-1891) was of the same opinion. He explained that, while posterity pays interest on government debts, it also receives earnings from capital that was built by predecessors with the help of borrowings. Vreden (1871) also added that debts enable government to increase spending on economic and social development.

Another actively discussed contention was that it is better to impose higher taxes than to incur debts. Belgian economist and sociologist E.L.V. de Laveleye (1822-1892) completely agreed with this point of view, maintaining that "in order to cover extraordinary expenses it is better to use taxes than loans as asserted and did great British minister Gladstone" (Laveleye, 1895). However, David Ricardo considered loans to be more advantageous to private capital preservation than taxes. Government usually collects taxes

equally from all business entities. Thus, taxpayers have to give not only spare capital, but also money that they need to invest in the development of their businesses. Government borrowings, on the contrary, attract solely spare capital on a voluntary basis. Rational management of public finance supposes that taxes and loans should supplement each other (Ricardo, 1820).

The third disadvantage of government debt still remains popular among proponents of economic liberal opinion. It was established by Adam Smith, who said that government debt negatively affects the amount of private capital and leads to its erosion. As a result, the rate of economic growth slows down. According to A. Smith's point of view, "the capital which the first creditors of the public advanced to government was, from the moment in which he 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" (Smith, 1776). Moreover, A. Smith claimed that in order to repay debts a government must collect additional taxes, which reduce the revenue of companies and households.

The theory of capital erosion was graphically illustrated by our contemporaries Paul Samuelson and William Nordhaus (1998). In Figure 1(a) we can observe a situation, in which government debt does not exist. Companies demand capital (D), while households supply capital (S). The two curves cross at point A, which means that households would be ready to invest 4000 money units at interest rate equal to 4%. In figure 1(b) we can observe, how a 1000-unit increase in government debt affects the amount of private capital. The households' supply of capital curve SS shifts 1000 units to the left to curve S'S', interest rate rise from 4 to 6 present and private capital decreases by 250 money units. This means that some savings would be invested in government liabilities instead of purchasing shares and bonds of commercial companies. Thus, firms will lack capital, which will slow-down their activity. It can lead to decrease of output, wages and national income.

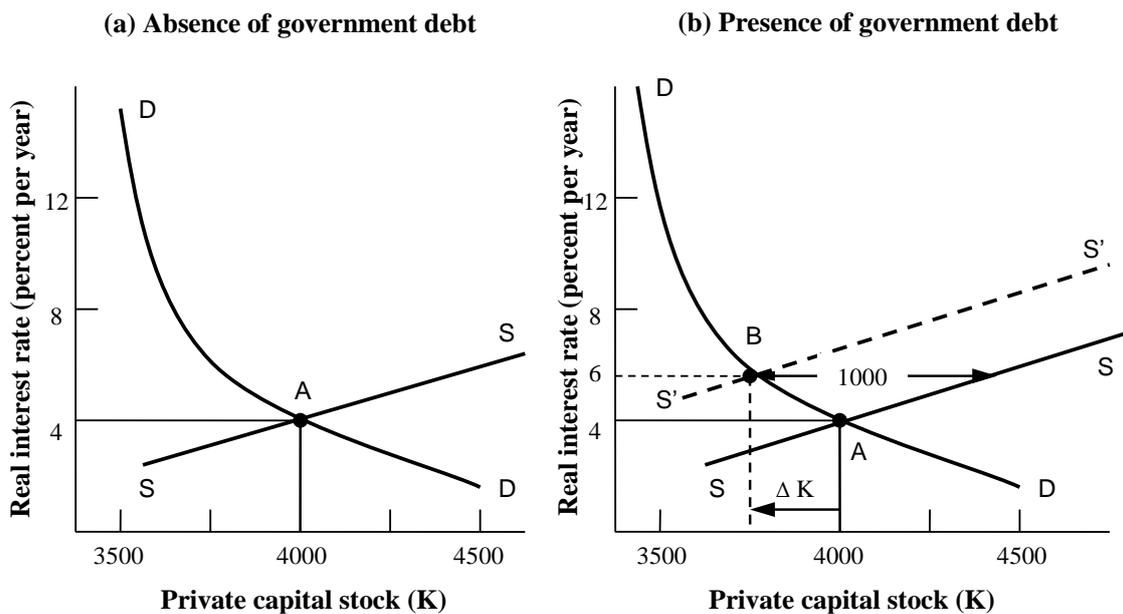


Figure 1. Government debt displaces private capital (Samuelson & Nordhaus, 1998)

However, the theory of capital erosion is weakened by several inaccuracies and disputed points. What if we think for a while that money invested in government securities would be spent on the development of profitable projects or would be distributed in the form of low-interest credits to the private sector, which would use it for industrial production. Such course of government policy wasn't even considered by Adam Smith and his followers. When this policy takes place in real life, the rise in government debts doesn't erode private capital. Government debts which are invested in profitable projects that are able to recover expenditures can be considered rational and effective. What is more, a moderate amount of government debt cannot cause huge and dangerous erosion of private capital. According to John S. Mill's opinion, the size of government debt is considered affordable until it becomes so big that it starts to

influence market interest rates (Mill, 1909). In that case debt must be reduced; otherwise, it will spoil economic development.

The fourth stage: government debt obtains all around justification

The fourth stage (20th century) is characterized by the advancement of additional arguments in favor of government debt and by the development of effective domestic debt management. Economists justified state borrowings mainly when they were required to stimulate economic growth or to ensure the country's defense capacity. As we know, the twentieth century was infamous for its two destructive world wars. Because of this, many economists tried to propose the most efficient way to finance combat operations.

Russian scientist Mikhail Bogolepov (1879-1945) believed that a country's financial defense capacity consisted of its ability to raise sufficient funds without any difficulties and in a short period of time. This would enable the government to cover all war expenditures and, ultimately, to win (Bogolepov, 1910). For example, very beneficial for USSR was credit contract with Germany, signed in 1939 between two military and political enemies (Muhin, 1999). According to this agreement, German firms had to provide turning machines, hydraulic presses, grinders and so on. This equipment was intended for new military plants. In return, the USSR was to provide raw materials, such as timber, tows, feathers and so on. So we can see that with the help of government credit, the German economy worked to the benefit of the USSR's defence industry.

As an alternative to external government debts, economists considered different internal methods of borrowing. For instance, in his paper "How to pay for the war" John Maynard Keynes proposed to introduce compulsory savings, in other words, money that people should loan to the government during war and receive back at peacetime (Keynes, 1941). However, Keynes became popular for another work called "The General Theory of Employment, Interest and Money" (1936), where he "shows how "wasteful" loan expenditure may nevertheless enrich the community on balance. Pyramid-building, earthquakes, even wars may serve to increase wealth". Keynes refuted the theory of capital erosion and said that, when the government borrows money and invests even in unprofitable projects, it creates jobs and the demand which is necessary to stimulate economic growth. When the government employs people and pays them, money supply increases and manufacturers can produce and sell more goods. Thus, businessmen build new factories and create new jobs, because demand stimulates supply.

In many respects due to tremendous government debt and demand-side economics, the USA became a powerful state, conducted the dollarization of the global economy, developed private crediting and investment and enhanced its standard of living. Many other countries followed this pattern of behavior, meaning that they applied policies of budget deficit and huge government debt in order to increase spending and make the economy prosper.

The fifth stage: international regulation and restriction of government debts

The world financial crisis, which began in 2008, initiated the fifth stage of political and economic opinions on government debt. Significant economic downturns forced governments to increase their debts in order to support private sector. In many countries nowadays the amount of government debt has become equal to the size of the Gross Domestic Product or even exceeded it (International Monetary Fund, 2011). Greece, Ireland and Portugal had considerable difficulties with debt redemption, which led to ongoing European sovereign-debt crisis. The USA also faced the same problem and covered old debts by new ones.

The more country borrows, the bigger its interest payments get because risks become higher. So, authorities have to raise taxes to continue paying interests on debts. As a result, excessive government debt usually leads to hyperinflation or deflation and damages the national economy. Monetization of government debt by open market operations of monetary authorities reduces the level of interest rates. However, it doesn't mean that production sphere will receive enough cheap investments to recover and accumulate capital. The increased money supply can be absorbed by speculators of stock exchange, as it may be more beneficial to invest in foreign currencies and risky securities than in the real sector of economy. Moreover, even if producers borrow money at low rates, it doesn't mean that their business will be efficient.

The rise of government debts up to a certain point doesn't lead to a deterioration of economic conditions. On the contrary, for a while, the increase in government spending stimulates demand, which encourages producers to increase supply. However, when the amount of government debts reaches its limit, further increase of state borrowings negatively affects the whole economic system. As we see in Figure 2, the

economy of the USA reached such a limit in 2007. After that moment, we don't observe any substantial growth of GDP. Demand cannot be stimulated any more with the help of government expenditures. From our point of view, global authorities for government debt regulation and limitation should be established in order to restrict the amount of borrowings and prevent the defaults.

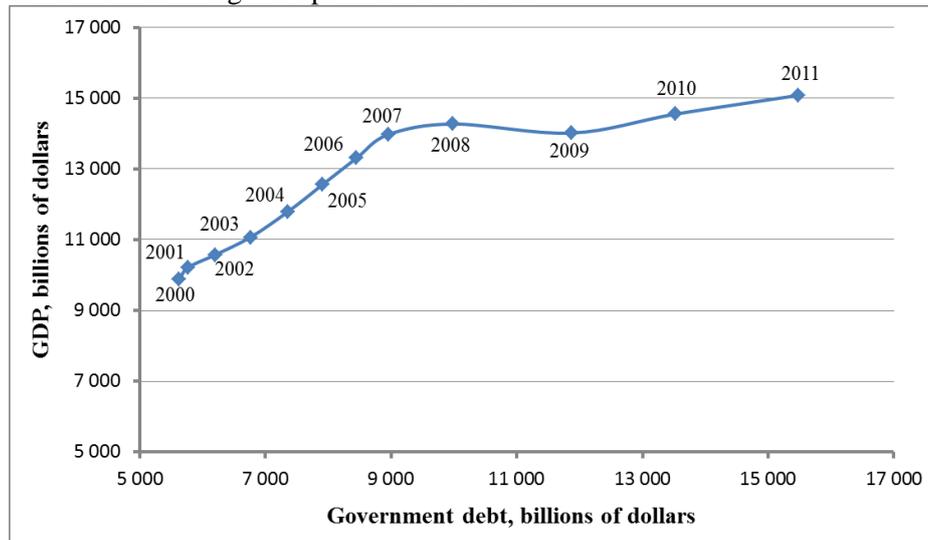


Figure 2. Correlation between the size of government debt and GDP growth in USA (International Monetary Fund, 2011)

In the fifth stage, economists should understand that endless government debt and pumping money into the economy cannot solve problems in the long term period. When the business cycle comes to a recession, it is a sign that something went wrong. Governments should carefully reveal and analyze the factors that caused the contraction. They may include inefficient production, the appearance of monopolies, high taxes, a necessity for technological innovations and so on. Only after the negative factors have been determined, should a government borrow money to solve particular problems. Otherwise, the recession will repeat itself, but with redoubled force, because the government has made thoughtless expenditures that have again increased demand for useless products.

Conclusions

As a result of conducted research, we revealed and gave a detailed account of five basic stages in the history of the government debt justification. The first stage was the longest one, when state borrowings were condemned for many reasons: subsistence economy, religious ban of usury, and scholastic theories based on natural law and the inherent sterility of money. So, in order to make up the budget countries' rulers resorted to various tricks, such as selling public positions, demanding hats full of live fleas and introducing forced loans. They also used more traditional methods: taxes, coinage debasement and rent. However, the dark Middle Ages were replaced by the Age of Discovery and Financial Revolutions.

During the second stage, government debt gained justification in cases of emergency like wars and natural disasters. This stage was triggered by the development of market economies, banking systems and separation of powers. However, the attention of economists was primarily focused on the disadvantages of government debts such as the increase of taxes and risk of sovereignty loss, which is still actively discussed.

During the third stage, owing to the extension of state involvement in the development of the national economy and the enhancement of the government's role as a creditor, government debt obtained an essential amount of supporters. Thus, the assertion that prosperity should not pay debts made by previous generations was successfully refuted. Moreover, some economists disproved the assumption that it is better to impose higher taxes than to incur debts. However, the biggest object of concern was the theory of private capital erosion established by Adam Smith. From our point of view, this theory is not applicable if money invested in government securities is used for the development of profitable projects.

The fourth stage is characterized by the advancement of additional arguments in favor of government debt. A country's ability to borrow money quickly, called financial defence capacity, is considered to be one of the key points in winning battles in expensive world wars. Also, economists justified government debt in

the case of the need to fight recession. Keynes's theory, which suggests that any government expenditures increase demand, stimulate supply and economic upturn, gained popular approval.

Detailed study of the first four stages has showed that attitudes toward the government debt evolved from total rejection to approval and all-round justification. However, global financial crisis, which began in 2008, indicated a transfer to the fifth stage, when government debts require reasonable restrictions and international regulation. In the 20th and 21st centuries, state borrowings grew gradually from year to year. Nowadays in many countries the amount of government debt has become comparable to the size of Gross Domestic Product. The substantial insolvency risk of some governments may lead to a second wave of crisis. Thus, economists should understand that simply pumping the economy with money doesn't solve the problem. Authorities must fight against the real causes of recession; otherwise, downturns will continue to occur again and again.

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