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Overview of the Main Theories on the Economic Effects of Public Indebtedness

Irina Bilan[1]

Abstract: The paper briefly reviews the main theories formulated over time on the economic effects of public indebtedness, with the aim to highlight their common and divergent points, the arguments they rely upon, as well as their relevance, given the current economic environment. Three major views are considered, namely the classical one, the Keynesian one and the view of neoliberal economists (monetarist economists and representatives of the school of rational expectations). The comparative approach of the different views allowed us to shape some criteria of decision which may prove useful for public policymakers in formulating public debt policies conducive to economic growth: public indebtedness should not become common practice but be reserved for those situations in which the economy is confronted with unusual phenomena, such as economic downturns; borrowed resources should be used especially on those destinations which create added value in the economy, such as public investment; public debt should not accumulate at a fast pace and should be kept within reasonable limits, to avoid possible side effects on economic growth.

Keywords: government debt; economic growth; classical theory; Keynesian theory; neoclassical view

JEL Classification: B10; B20; H63

1. Introduction

If an omniscient and objective witness of history was called upon to give a verdict on the rationality of states indebtedness, one thing would be certain: his task would be extremely difficult and his answer far from being categorical. The realities of different countries and different periods have shown that the indebtedness of public authorities can entail both positive and negative effects on various aspects of social and economic life (including on the economic growth rate of the country in question), the extent to which they occur and their proportions depending on numerous factors, some under the direct control of the indebted authorities (possibly the result even of their decisions), while others with a broader spectrum of action, the manifestation of which may sometimes be hardly anticipated.

Unfortunately, in the realm of economic theory things are not much clearer. The views of various economists, outlined in relation to the specifics of their times, oscillate between recognizing, in varying proportions, the need for public borrowing and the possibility of incurring beneficial effects on its account (for example when it is supported, in this way, the economy in recession), and blaming the state's right to use public loans, as responsible for many “bad things” in the economy and society (Bilan, 2015).

[1] Senior Lecturer, PhD, Faculty of Economics and Business Administration, "Alexandru Ioan Cuza" University of Iași, Address: 11 Carol I Blvd, Iasi, Romania, Tel.: 0232/201440, Corresponding author: irina.bilan@uaic.ro.

Our paper aims to review the main theories formulated over time on the economic effects of public borrowing, highlighting their common and divergent points, as well as the arguments they rely upon. The comparative approach of different views and their analysis by reference to the current economic situation will allow us to shape some criteria of decision which may prove useful for public policymakers in formulating public debt policies ensuring favorable conditions for economic growth.

2 The Classical View on Public Indebtedness and its Economic Effects

From the standpoint of the classical doctrine (having as representatives the well-known A. Smith, R. T. Malthus, D. Ricardo, J.S. Mill or J.B. Say), the outlook appears to be predominantly unfavorable to public borrowing. Faithful to the principle of "laissez-faire" and the regulatory actions of market forces, the classics attributed to the state only the role of ensuring the smooth ongoing of economic relations, public authorities not being allowed to intervene in the economy. Arguing that public expenditure are unproductive, in relation to the traditional tasks undertaken by the state (public order, national defense, diplomatic relations, etc.), and that resources are managed more wastefully in the public sector compared to the private one, the classics blamed state indebtedness considering that it distorts private capital from its productive function to non-productive uses, thus affecting the accumulation (and hence stock) of capital and the growth and development of the economy, as a whole.

The vision of Adam Smith is relevant to this view, one of the arguments he puts forward to support the denial of the state's right to incur debt being that indebtedness delays the natural progress of a nation towards wealth and prosperity since, in this way, resources that would receive productive destinations in the private sector are diverted by the state to cover its unproductive expenditure, thus being wasted without any hope of future reproduction. The effects of contracting public loans in terms of capital accumulation (and thus, long-term economic growth) are considered to be even more harmful than those of taxes, since public borrowing leads to the reduction of existing production capacities through "the perversion of some portion of the annual produce which had before been destined for the maintenance of productive labour towards that of unproductive labour" (Smith, 1904). The negative effects on the accumulation of productive capital in the economy are also confirmed by David Ricardo, who states that "when, for the expenses of a year's war, twenty millions are raised by means of a loan, it is the twenty millions which are withdrawn from the productive capital of the nation" (Ricardo, 2005).

However, a different approach can be found at Thomas Malthus who, anticipating the possibility of imbalances under the form of overproduction of goods (entailing a gap between the supply and demand of goods), admits in this situation (subject to the lack of other possible alternatives) to use borrowed resources to increase demand for goods and services, thus making up for the economy's failure to self-regulate. Consequently, Malthus advocates for maintaining "an adequate level of public debt because otherwise the generalized overproduction of commodities from a mere possibility will become a harsh reality" (Tsoulfidis, 2007).

At the same time, continuing the approach of his predecessors but being concerned about a deeper analysis of the effects of public debt, John Stuart Mill identifies situations where it does not necessarily act detrimental to the accumulation of productive capital, for example when the state diverts, by giving them more advantageous uses, the savings immobilized in unproductive companies or to be placed outside the country, or when the borrowed resources come from abroad (Tsoulfidis, 2007). In such circumstances, Mill accepts that upward pressures on interest rates do not occur and, therefore, public debt is not necessarily accompanied by harmful effects on economic growth. Insofar as, by borrowing, public authorities do not limit themselves to raise in this way unused savings, but compete with the private sector for resources that would otherwise be invested productively, Mill believes that public debt becomes harmful for the economy, and so the use of borrowed resources is to be condemned.

Openness to state intervention and modernity is anticipated by some representatives of the German historical school who, unlike classical economists, assign to the state an expanded role, considering it an active agent of the socio-economic progress (Todosia, 1994), change which is also reflected in the modified optics on public indebtedness and its possible effects. Although he assimilates classical ideas, accepting that public indebtedness can divert capital from its productive uses in the private economy (the increase in the interest rate being the criterion for assessing the intensity of this effect), Adolph Wagner admits, just like Mill, that public borrowing is nevertheless to be accepted when, in this way, are raised unused resources available in the national economy or resources from abroad. Wagner's more substantial contribution to assessing the economic effects of public debt arises, however, from delimitating different public spending types based on the time framework of their effects, and associating them with appropriate funding sources. Thus, in the case of public investment expenditure (non-recurrent expenditure) debt financing is not only accepted but even preferable to tax financing, while government borrowing to cover normal public expenditure (recurrent expenditure) is completely prohibited, the disregarding of this rule leading to chronic budget deficits, “a path towards ruin, because the growing interest burden would throw public finance into the abyss” (Holtfrerich, 2013).

3 The Keynesian View on Public Indebtedness and its Economic Effects

A fundamental change of perspective, produced in the context of the extensive mutations and socio-economic and political challenges of the first half of the twentieth century, comes with the Keynesian doctrine, doctrine fundamentally attached to the ideas of J.M. Keynes, but also developed by other economists predecessors, contemporaries and successors of Keynes. Placed at the opposite side of the classical doctrine, the Keynesian doctrine alters the very liberal assumptions and principles that the former relies upon. Specifically, in response to the challenges of those times (in particular, the economic downturn), the new doctrine attaches great importance to the state, whose interventions in economy and society not only are no longer blamed, but are called to supplement the actions of the market and to correct its imperfections.

Regarding the economic effects of public indebtedness, the Keynesian view delineates fundamentally from that of the classical economists, as public borrowing ceases to be blamed for its damaging consequences, and is evidenced, on the contrary, in the foreground, its contribution to the smooth functioning (without major imbalances) of the economy. Two major arguments support this change of perspective.

First, by accepting the extension of the scope of the state, public expenditure (at the funding of which public indebtedness contributes) cease to represent, in their entirety, definitive and unrecoverable consumptions of resources, negatively affecting the national wealth and the prosperity of the nation as a whole. The involvement of public authorities in value adding activities (e.g. public works, which are recommended by Keynes) permits, on the contrary, to avoid negative effects as the above ones and contributes to economic growth and development.

Secondly, the reconsideration of the role assigned to public authorities, in the sense of assuming the task of countering disturbing economic and social phenomena, gives new meanings to public borrowing, as ways of intervention to correct imbalances and ensure an upward evolution of the economy.

From this perspective, it seems relevant to highlight the role assigned to public indebtedness by some adepts of the Keynesianism (A.H. Hansen, J. Hicks, P. Samuelson, etc.) in designing demand-side fiscal policies for relaunching the economy in recession or stimulating balanced economic growth. Inspired by the realities of the global economic crisis of 1929-1933 and based on the extensive theoretical construction of Keynes, such policies propose the engaging of the state, through its financial means, in supporting economic recovery and fighting unemployment, in times of recession, or in accelerating the pace of economic growth, when it is too slow or the economy is stagnant. More specifically, measures are adopted aimed primarily at increasing public consumption or investment spending, without excluding, however, tax measures (tax cuts, tax exemptions, etc.) (Filip, 2010). Such measures help increase overall demand and, in this way, stimulate the increasing of the supply of goods and services, the GDP growth and employment.

Most often, such measures involve accepting (as deliberately produced/ premeditated) imbalances between a lower level of ordinary budget resources (consisting mainly of taxes) and a higher level of budget expenditure, i.e. accepting budget deficits which are funded, along with other extraordinary resources, by means of public borrowing leading to higher public debt. Although, in the view of some Keynesians, inflationary currency issue is not to be avoided, public indebtedness would allow, in addition, bringing in this way into the economic circulation the unused revenue of certain social categories, namely those savings not materialized in investments, in order to finance public spending. On these grounds, public indebtedness appears in the Keynesian view as an indispensable tool to ensure the balanced growth of the economy.

Although, in general, the Keynesian view assigns positive connotations to public indebtedness, its use is subject to strict limits. Such limits result from the "controlled" promotion of negative budget balances, only in periods of economic recession or stagnation, without accepting them in periods of expansion (to become permanent). In this respect, it appears to be relevant the systematic deficit theory developed by W. Beveridge, based on Keynes's view that although it should be admitted that "getting out of the crisis is based precisely on public loans to finance an increase in public spending, and therefore a budget deficit", after the stagnating or declining economy is relaunched the public budget should return to equilibrium (Filip, 2010). At his turn, M. Duverger said that "the budget deficit (A/N and so the creation of new public debt) must cease as soon as the full employment is reached" (Duverger, 1975).

Reducing budget deficits and returning to budget balances are, in fact, possible precisely because of state's actions, resulting in increased production, incomes and thus fiscal resources. In an optimistic manner, Keynes said in this regard that it is enough "to deal with unemployment, because the budget will take care of itself (A/N and debt will reduce by itself) (Keynes, 1982).

4 Public Indebtedness and its Economic Effects in the View of Neoliberal Economists

The powerful resurgence of economic liberalism in the 1970s, through the representatives of the neoliberal doctrine, marked a new change of perspective reviving, according to the precepts of the "good" classical liberal doctrine, the disapproval of state's indebtedness. According to them, "whatever the relative position of the country in question, increasing deficits (A/N and public debt) express the promise of future economic difficulties (...) and reduced welfare" (Landais, 1998).

From the position of ***monetarist economists,*** as a counterweight to Keynesian solutions and therapies, they are denied the positive results of any budgetary measure aimed at stabilizing the economy, especially from the perspective of a longer period of time, and is therefore contested the ability of public authorities to act, by promoting budget deficits and financing them by means of borrowing, with the aim to relaunch the stagnating economy or in decline. In this regard, referring to the role of the public budget, Milton Friedman said that "far from being a balancing mechanism to offset other forces that ease fluctuations (...) it was itself a major disruptive factor and generator of instability" (Friedman, 1995).

The main argument to justify the disapproval of state's indebtedness arises from the emergence, when public authorities turn to public loans to finance budget deficits, of a negative effect called the "crowding-out effect". Looking at the market for loanable funds, the crowding-out effect broadly assumes that, when public authorities indebt themselves by raising public loans, the demand for loanable funds increases while the offer remains unchanged, which results in an increase in the interest rate on this market. This in turn reduces private investment (sensitive to interest rate changes), and so private capital funds "flee" towards the public sector to serve public expenditure financing. Overall, the monetarists emphasize that, in this way, it is possible that the anticipated positive effect on GDP growth produced on the account of promoting debt-financed budget deficits becomes very low, even null.

From the Keynesian position, this effect was, however, strongly contested. Keynesians especially invoked that, given the conditions of an economy that is not working at full capacity and where there is a significant amount of unused resources (as can be characterized the context of the Keynesian analysis), the debt financing of budget deficits, by means of public loans placed on the financial markets, helps draw these resources into the economic circuit. In this way, the offer for loanable funds grows equally to the demand and, thus, the interest rate may remain unchanged.

A different view on the economic effects of public borrowing is expressed by the representatives of the ***school of rational expectations***, in particular by R. J. Barro who, based on the theoretical grounds laid down by Ricardo, gives course to the Ricardian equivalence thesis. Challenging the Keynesian reasoning, Barro claims debt neutrality on the grounds of the equivalence, in terms of their effects, between the financing of a certain amount of public spending through the ordinary alternative of taxes or by public borrowing. Specifically, he believes that governments, by deciding to give up some taxes and resort to borrowing to finance resulting budget deficits, accumulate public debt that, just like privates, will have to repay in the future, and so will have to resort to future tax increases. This future "tax invoice" is considered to be perfectly anticipated by private agents and incorporated into their behavior, so they react by raising their present savings equally to the amount of future additional taxes. Thus, the additional private revenue generated on the account of tax cuts, instead of being used for increased consumption, investment and demand is found, especially, in increased savings for precautionary purposes (Caron, 2007). In this way, the possible positive effect arising, according to the Keynesian view, on the account of debt financed budget deficits is canceled, which therefore reveals the neutrality of public debt.

5 The "Conventional" View on the Economic Effects of Public Indebtedness.

The view currently assumed by most economists and even by some public policy makers, therefore called the "conventional" view (Elmendorf & Mankiw, 1998), combines classical (liberal) arguments and Keynesian ones, distinguishing between the effects of public debt on economic growth over the short-term and over the medium- and long-term.

From the perspective of a short period of time, the framework of analysis is considered to be Keynesian in nature, so the supply of goods and services and, therefore, the output appear to be determined by the level of demand, which at its turn can be influenced by public borrowing to finance increased budget deficits. So, public indebtedness can prove to be beneficial for the economy over the short-term, especially when the economy is in recession or confronted with weak growth rates, and when the actual GDP is well below its potential level.

Faced with the "painful" realities of the recent crisis, many economists argued for Keynesian therapies. Paul Krugman (Krugman, 2009) emphasized that "they (A/N the economists) have to admit (...) that Keynesian economics remains the best framework we have for making sense of recessions and depressions." This view was fully reflected into the public indebtedness policies promoted, with the onset of the global economic crisis, by the public authorities of the European Union Member States, many of them deciding to increase public spending or cut down taxes and therefore borrowing to support the economy and ensure an upward economic trend.

From the perspective of a longer period of time, the framework of analysis is considered to be classical in nature, so the impact of the demand becomes less relevant and what matters for economic growth, on the contrary, is the supply of factors of production. The indebtedness of public authorities, to finance budget deficits, is considered to result in the reduction of total (public and private) savings, the increase of the interest rate, decrease of investments and the reduction of capital stock. Thus, its effects on economic growth appear to be mostly negative ones.

6. Conclusions

The short overview of the most relevant theories outlined, along time, on the effects of public indebtedness on economic growth fully proves that a unanimous consensus in this regard does not exist, as the practice of various countries indicates uniform results. An extensive study of the International Monetary Fund on the current and past situation of various countries concluded that "there is no simple relationship between debt (A/N public) and growth" (IMF, 2012), as many factors affect the relationship of determination between them.

The identification of these factors and of the causal links that they mediate, on the realm of economic theory, allows us to outline some common generic landmarks, serving public authorities to fundament (on rational grounds) their public indebtedness decisions. In order to allow for positive effects of public borrowing on economic growth rates, or to limit any possible negative effect, public policymakers should consider, in our opinion, three fundamental aspects when deciding to incur debt:

a. ***The economic conditions*** - Public indebtedness must not become common practice but, on the contrary, this option should be reserved especially for those situations in which the economy is confronted with unusual phenomena, requiring large scale government interventions and important financial (public) resources. Going through a period of severe economic downturn is the best example in this respect, but can be assimilated natural disasters, transition to market economy, large scale structural reforms (e.g. the reform of the pension system to meet the challenges driven by aging population), etc.

b. ***The destination of borrowed resources* –** The financial resources raised by means of borrowing should be used, especially, on those destinations which allow creating added value in the economy, over the medium- and long-term, thus ensuring the prerequisites for future repayment, without major difficulties, of resulting public debt (borrowed amounts and interest expenditure). Such destinations mainly include investment expenditure, which Keynes himself recommended, although not any public investment should be a priori accepted, but only those with high economic and social efficiency. Investment in physical capital are added to those in human capital (such as those resulting from public spending on education or health care), with positive effects on economic growth and development over the long-term.

c. ***The dimensions of public indebtedness* -** By the dimensions of public indebtedness we mean both the rate at which public debt is accumulated and the overall size of the debt, given the amount of previous financial commitments. When public debt is large or accumulates at a very fast pace, the likelihood of possible side effects (interest rate increase, private savings increase, etc.) to occur increases and this may have negative effects on the economic growth rate.

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