Pleasant Dreams or Nightmares in Public Debt Scenarios?

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Past and current views on public debt

In his recent book on 'The Euro Trap: On Bursting Bubbles, Budgets, and Beliefs' (2014), Hans-Werner Sinn worries that "nearly all [the EU countries have] increased their sovereign debt faster than their GDP" (p. 55). EU countries were not the only ones to do so, despite the poor reputation enjoyed by public debt for several hundred years up until the mid-20th century. Several famous historical personalities, including Cicero, George Washington, Napoleon and others, warned about the danger of public borrowing. Economists including Adam Smith and David Hume shared these concerns.

Naturally, there were situations or good excuses that, at times, seem to justify public borrowing. In the past, governments did not have modern tax administrations capable of collecting taxes when needed. In many cases loans could be obtained more quickly and more easily. So governments did borrow even in the past. The historical figures and economists of the past might have approved of public debt in situations that included: (a) fighting legitimate wars; (b) dealing with the consequences of great natural disasters; and, in recent times; (c) public borrowing during severe recessions. Some economists today may also approve of public borrowing to finance *a big push* in infrastructure creation. However, there is disagreement over whether *routine* public investment spending, that does not change much year on year, should be financed by borrowing rather than by taxes, as defenders of the so-called *golden rule,* have argued. Not all *public investment* is productive, and not all of it contributes to economic growth and to future tax revenue (Tanzi and Davoodi 1998). Furthermore, corruption often inflates investment spending.

Many modern economists would also agree that fiscal deficits, which arise during recessions from the action of 'built-in-stabilisers', can also justify public debt. However, many economists would disagree with the view, currently held by some very vocal economists, that when the growth rate falls below what they believe is the long-run trend, this fall justifies *large and sustained* fiscal injections. In all of the above situations, a country that has kept its public accounts in good order would have less difficulty in borrowing. This means that the *initial conditions* of a country's fiscal accounts are important in determining the fiscal policy that is feasible and desirable (Tanzi 2015a and 2015b).

The realisation that there can be Great Depressions or Great Recessions justifies (for many modern economists) the necessity of fiscal policies that may help to stabilise the economy. This led Keynes to propose the use of *time-limited, expansionary* fiscal policies in the 1930s, mainly associated with public spending on productive public works, financed by public borrowing. He also theorised that fiscal multipliers would create more employment and more output than the initial fiscal stimulus would have.

Concerns over high unemployment during the Great Depression in the 1930s also led Keynes to state that governments should prioritise short-run objectives, because, as he put it, "in the long run we are all dead". That statement has often been cited to suggest that the short-run should be the focus of counter-cyclical fiscal policies and that policy has paid little attention to the implications of high and growing public debt. Counter-cyclical fiscal policy should be symmetric over longer periods of time. It should generate budget deficits during recessions and budget surpluses during better times. It should not, however, lead to the accumulation of large public debts.

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Since the end of World War II, the industrial countries have not fought great wars; have not experienced major natural disasters; have not experienced Great Depressions; and have not engaged in major public investment programs concentrated in short-time periods, like, for example, China has done. Furthermore, spending on public infrastructure has been reduced in recent decades. Nevertheless, public debt has grown, hitting historical highs in some countries. In spite of these levels, some economists have urged governments to spend and borrow more. In their view, this course of action would stimulate the economy and enable the government to take advantage of the low interest rates that the central banks have made possible.

New Keynesian views on fiscal policy

Some economists have recommended (and some governments have adopted) such policies, which are described as 'New- Keynesian', although it is not certain whether they would have received Keynes' stamp of approval if he were alive today. They reflect a belief that, with enough public spending, any country can prosper and grow. Public spending is seen as the basic growth factor.

Changes in paradigms often start with changes in the meaning of some terms. This has happened in the discussion of fiscal policy. Terms such as 'austerity', 'recession', 'growth', and others have been subjected to some massaging of their meanings. These new definitions have accompanied new and, at times, even strange economic theories that seem to ignore obstacles to growth of a *structural or psychological nature.* The implicit belief of the New-Keynesian theories seems to be that very large fiscal multipliers exist and that more public spending can generate miracles. Large fiscal deficits can raise growth rates, especially in 'deeply depressed' economies. These high levels of public debt would not create difficulties, because the anticipated high growth rates would melt such debt.

Given these assumptions, it would be 'stupid' (Stiglitz' term) to worry about fiscal deficits and public debt. The media attention devoted to the few, highly vocal economists who hold these views, gives the impression that they now reflect the views of the economic profession. However, many leading economists do not share this belief.

As a result of the new theories, some research in the fiscal area has become more *creative* and less *intuitive*. Some economists have argued that traditional, orthodox, economic rules no longer apply, when the economies are deeply depressed, and when 'liquidity traps' are present. Some empirical studies have generated outcomes that orthodox economists find highly questionable and difficult to accept. The latter have found it increasingly hard to understand the channels and the mechanisms that can create the huge multipliers and the claimed large growth outcomes.

Public debt and its impact on economic activity

Various papers have advocated expansionary fiscal policies and a slower pace of fiscal consolidation on the part of countries with high fiscal deficits and large public debts. At the beginning of the financial crisis, some economists set the tone for the policies that advanced countries should follow to deal with the crisis. An important IMF paper called for the adoption of *large, expansionary* and *sustained* fiscal policies. Various countries introduced policies that increased their fiscal deficits to extraordinarily and clearly unsustainable levels in 2009–2010. These fiscal stimulus packages were withdrawn when the money budgeted for them was spent. However, the deficits remained very large. In 2012 they averaged over 6 percent of GDP in the G7 countries, but some economists nevertheless defined them as 'austerity' (Tanzi 2015a). Austerity has come to describe the policies of countries that did not maintain the fiscal deficits at the extraordinarily levels of 2009–2010.

The criticisms imply that the policies followed after the introduction of the large 'fiscal packages' of 2009 were too restrictive, and that governments should have maintained their large fiscal stimuli. As interpreted in a 2015 IMF study, the current fiscal and economic conditions of many countries would justify and allow them to introduce much *additional and sustained*, fiscal expansionary. Very large fiscal multipliers are now assumed (see DeLong and Summers 2012) and operate over much longer time periods (see Blanchard and Leigh 2013). Thus, in the views of the economists behind these new theories, the large, expansionary fiscal policies should be sustained for much longer periods to fight stagnation. These economists believe that we are now in a different fiscal world where old rules no longer apply.

The world risks drowning in an enormous pool of public (and private) debt, if the recommended policies fail to generate the fast rate of growth that those who propose them hope they will generate. In a 2015 report Mckinsey & Co. provided useful statistics on global public and private debt. Total debt worldwide has never been so high. This report warned that high debt levels have historically placed a drag on growth and have raised the risk of financial crises that could trigger deep, economic recessions. In a recent book, the author of this paper argued that large and growing disequilibria in the public finances of many European countries, some hidden by questionable and non-transparent fiscal accounts, or by faulty data, made the financial crisis more severe than it would otherwise have been (Tanzi 2013).

High public debt may depress growth through various channels. The most direct of these channels is that servicing public debt diverts public spending away from public investment. This relationship was first theorised and empirically tested in Tanzi and Chalk (2002) and was confirmed by later studies (Ostry *et al*. 2015; Chudik *et al*. 2015). Some economists have qualified the negative relation between public debt and growth. For example, Ostry *et al*. (2015) state that, despite the negative impact seen (of high debt on public investment and on growth), the analytical framework implies that, in general, it is better (for growth and welfare) to live with high debt than to try to reduce it through distortionary taxation. While this may be true, the 'distortionary taxation' may not be the only, or indeed the most desirable way to reduce a high debt in most countries. A better way would be to cut unproductive spending, as many IMF studies have found. In recent decades some countries successfully cut public spending (sometimes by very large shares of GDP) to deal with high and growing public debts (Tanzi 2011).

High public debt may reduce growth through channels other than the impact on public investment and on tax levels (Reinhart *et al*. 2012; Cecchetti *et al*. 2011). It can also depress growth by creating concerns about the sustainability of fiscal policy and the increasing likelihood of financial crises (Baker *et al*. 2013). A casual look at countries with high public debt levels reveals that they have not been blessed by high growth rates.

Debt statistics and future prospects

The Mckinsey report listed 23 countries, including the G7, which had ratios of total (public and private) debt of over 200 percent of GDP in 2014. In many countries private debt has shown a tendency to become public debt during crises. Increasing shares of public debt have been parked in the balance sheets of the central banks, as Sinn (2014) highlighted for the EMU. The consequences of these developments are difficult to predict.

While the data cited above are statistical facts, some economists have become less antagonistic to public debt, and have even turned public debt from a sin into a virtue. Central banks have encouraged this conversion by keeping the cost of short-term debt very low for governments. Today many countries have public debts that exceed 100-percent of their GDP. In 2014 the debts of general governments, as percentages of GDP, were: 246 for Japan; 177 for Greece; 132 for Italy; 130 for Portugal; 107 for Belgium; 108 for Cyprus; 105 for the United States; and 108 for Ireland. Several other countries (Canada, France, Singapore, Spain and Britain) had debt/GDP ratios of close to 100 percent (IMF Fiscal Monitor, October 2015). These debts grew in 2015.

The supply of credit to governments has become progressively more elastic due to the globalization of financial markets, the growth of shadow banking, the high saving rate of China, as well as the novel and more accommodating policies of central banks. Monetary policy has become increasingly more dependent on fiscal developments.

Some recent economic literature has attempted to define an *optimal or safe* public debt level, recognising that such a level is rather difficult to pin down precisely in practice. Ostry *et al.* (2015) has suggested that debt levels fall into three zones: a green zone, a yellow zone and a red zone. For countries in the green zone reducing debt is likely to be normatively undesirable, as the costs involved in reduced output will be larger than the resulting benefits. Those countries in the green zone, which covers most counties, have considerable fiscal scope for manoeuvre ranging from 100 to 200 percent of their GDP. Japan, Italy, Greece and Cyprus are the countries in the red zone that face inflexible debt limits: these countries should refrain from adding to their public debt levels. The countries in the yellow zone have fiscal space that they can still use debt finance, but must exercise some caution.

One can only wonder at these estimates, especially given their source. For example, is it reasonable to assume that the current fiscal space of Belgium is 124 percent of GDP, that of Spain is 118 percent, and that of France is 117 percent? What would happen if all the countries in the table decided to use their estimated fiscal space? We know that all of these countries will face significant age-related public spending in the future. Some have large, unfunded, pension liabilities that do not show in their official public debts statistics. If added to the official estimates of the public debt, these liabilities would raise the public debt level considerably. In addition, interest rates in recent years have been very low. These favourable factors are likely to change in the future, creating a far less favourable environment for countries with high public debts. For many of these countries the maturity of their debt is relatively short and their future economic growth rates are also likely to be lower.

A few years ago Standard and Poor's estimated the future impact of ageing on public spending in many industrial countries, under the laws that existed when the estimates were made. It found that all of the countries in the table will be severely affected by ageing. By 2050, several countries will need as much as ten or more percentage points of GDP in public spending to cover the increasing costs of ageing. Many of those living today will still be alive and retired in 2050.

Over the past two decades there has been growing resistance on the part of the citizens of OECD counties to pay higher taxes. Statistics provided by the OECD indicate that the highest taxes (expressed as a percentage of GDP) were achieved in the 1990s. Almost no country has increased its tax level significantly since then. The obvious question to ask must be: how will the countries be able to service their current, or even higher future public debts, at interest rates that seem likely to rise, while, at the same time increasing public spending, in some cases by very large amounts, to cover the costs of ageing populations, of infrastructure requirements, of climate change and other factors? An answer to this question is urgently needed.

Concluding remarks

This paper has dealt with the rise of public debt in recent years, and with the push, on the part of some vocal economists, for governments to increase public spending and to abandon what they call austerity, in the belief that this policy will promote *sustained* growth. The paper has discussed how attitudes *vis-a-vis* public borrowing have changed and become more relaxed; and how some economists have come to see higher public spending as a kind of miracle cure that will increase economic growth in the long run. The article has provided some arguments that highlight the extent to which public debt has become a pressing current and future problem.

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