

The history of the political economy of public debt

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The initial incentive for this paper was the debt crisis in the periphery of the Eurozone and especially in Greece with disastrous results. *La Década Perdida* in Latin America in the 1980s had similarities and lessons to be learnt.¹ As a historian of economic thought I went back to look on the origins of the analysis of public debt. Some of the ground I will cover is well trodden, sometimes part of the potted histories that preceded textbooks on public finance, at a time when scholars thought necessary to present their arguments after a brief recapitulation of the arguments that preceded their own, or in some other cases – like James Buchanan – in order to make a point that new theories have an old – albeit fallacious – pedigree.² I have used this material and re-visited the old places reaching to a period where such recapitulations were no longer thought necessary.

I will not review Marxian theories of public debt in this paper. Nevertheless, I cannot resist the temptation to quote from the first volume of *Das Kapital*, Marx's characterization of public debt as an instrument of the so-called primitive accumulation:

¹ See for example Joseph E. Stiglitz and Daniel Heymann (eds), *Life after Debt: The Origins and Resolutions of Debt Crises*, IEA Conference Volume No. 152, Houndmills, Basingstoke: Palgrave Macmillan.

² Cases of such recaps are, e.g., Bastable, Leroy-Beaulieu and Wagner. Shutaro T. Matsushita, in his doctoral dissertation *The Economic Effects of Public Debts*, (New York: Columbia University Press, 1929) precedes his analysis with a long chapter on the history of the concept. James Buchanan in the *Public Principles of Public Debt* (Homewood, Ill.: R. D. Irwin, 1958), pp. 16 *et seq.*, reviews several theories in order to show that the (then) “new orthodoxy” was in fact quite old. It was a time when Joseph Shield Nicholson (1920) and R.O. Roberts (1942) could write in mainstream journals articles on the views of Adam Smith and David Ricardo on public debt in order to derive useful conclusions for economic policy. J.S. Nicholson, “Adam Smith on Public Debts”, *Economic Journal*, 30 (117) (March 1920), pp. 1-12 and R. O. Roberts, “Ricardo's Theory of Public Debts”, *Economica*, New Series, 9 (35) (1942), pp. 257-266.

The system of public credit, i.e. of national debts, the origins of which are to be found in Genoa and Venice as early as the Middle Ages, took possession of Europe as a whole during the period of manufacture. The colonial system, with its maritime trade and its commercial wars, served as a forcing-house for the credit system. Thus it first took root in Holland. The national debt, i.e. the alienation of the state - whether that state is despotic, constitutional or republican - marked the capitalist era with its stamp. The only part of the so-called national wealth that actually enters into the collective possession of a modern nation is - the national debt.

Hence, quite consistently with this, the modern doctrine that a nation becomes the richer the more deeply it is in debt. Public credit becomes the *credo* of capital. And with the rise of national debt-making, lack of faith in the national debt takes the place of the sin against the Holy Ghost, for which there is no forgiveness.

The public debt becomes one of the most powerful levers of primitive accumulation. As with the stroke of an enchanter's wand, it endows unproductive money with the power of creation and thus turns it into capital, without forcing it to expose itself to the troubles and risks inseparable from its employment in industry or even in usury. The state's creditors actually give nothing away, for the sum lent is transformed into public bonds, easily negotiable, which go on functioning in their hands just as so much hard cash would.

At their birth the great banks, decorated with national titles were only associations of private speculators, who placed themselves by the side of governments and, thanks to the privilege they received, were in a position to advance money to those governments. Hence the accumulation of the national debt has no more infallible measure than the successive rise in the stocks of these banks, whose full development dates from the founding of the Bank of England in 1694. The Bank of England began by lending its money to the government at 8 per cent; at the same time it was empowered by Parliament to coin money out of the same capital, by lending it a second time to the public in the form of bank-notes. It was allowed to use these notes for discounting bills, making advances on commodities and buying the precious metals. It was not long before this credit-money, created by the bank itself, became the coin in which the latter made its loans to the state, and paid, on behalf of the state, the interest on the public debt. It was not enough that the bank gave with one hand and took back more with the other; it remained, even while receiving money, the eternal creditor of the nation down to the last farthing advanced.³

What makes, however, debt or credit, public? There are historical accounts of institutions similar to modern public credit that concern debt assumed by collectivities such as monasteries or the finances of kings and princes during the era of mercantilism.⁴ The first analyses of public debt formed part of the Tory-Whig propaganda war after the English Financial Revolution.⁵

³ *Das Kapital, Band 1*, (1867). pp. 782-3 in *Karl Marx - Friedrich Engels - Werke*, Band 23, „Das Kapital“, Bd. I, Dietz Verlag, Berlin/DDR 1968. English text from Karl Marx, *Capital: A Critique of Political Economy, Volume One, Introduced by Ernest Mandel, Translated by Ben Fowkes*, Penguin Books in association with New Left Review, Harmondsworth, Middlesex, England [and elsewhere]. 1976, pp. 919-920. The text appeared in the 3rd edition (1883).

⁴ See especially the contributions in Jean Andraeu, Gérard Béaur & Jean-Yves Grenier (dir.), *La dette publique dans l'histoire* : « Les Journées du Centre de Recherches Historiques » des 26, 27 et 28

Daniel Defoe in an anonymous pamphlet written in 1710 at the behest of Robert Harley – to whom sometimes it is erroneously attributed – tries to fathom the ontology of public credit in philosophical terms:

Like the Soul in the Body, it acts all Substance, yet is it self Immaterial; it gives Motion, yet it self cannot be said to Exist; it creates *Forms*, yet has it self *no Form*; it is neither Quantity or Quality; it has no *Whereness*, or *Whenness*, *Scite*, or *Habit*. If I should say it is the essential Shadow of something that is Not; should I not Puzzle the thing rather than Explain it, and leave you and my self more the Dark than we were before? (1710, p. 6)

He describes, however, two basic characteristics of public credit: First, the fact that is *public*, i.e., national, and that it resides in the Queen and Parliament:

CREDIT is not the Effect of this or that Wheel in the Government, moving regular and just to its proper Work; but of the whole Movement, acting by the Force of its true original Motion, according to the exquisite Design of the Director of the whole Frame.

Thus the *Honour*, the *Probity*, the *exact*, punctual *Management*, which has raised our *Credit* to the pitch it is now arriv'd at, has not been merely the Great Wheel in *the Nations Clockwork*, that turn'd about the Treasure, but the Great Spring that turn'd about that Wheel, and this is the QUEEN and PARLIAMENT (1710, pp. 16-17).

Secondly, this being the foundation of public credit its *continuity* must be assured.

That as the Publick Credit is *National*, not *Personal*, so it depends upon No *thing* or *Person*, No *Man* or *Body of Men*, but upon the Government, *that is*, The Queen and Parliament; displacing or removing any Minister of State, or great Officer, whose Management under the Sovereign affects our Treasure, can no way influence our *National Credit*; while the Just, Honourable and Punctual Conduct of the Sovereign and Parliament remains the same. Neither does our Credit depend upon the Person of the Queen, *as Queen*, or the individual House of Commons, *Identically*; as if *no Queen* but her present Majesty, and *no Parliament* but the present Parliament, could support and uphold the Credit of the Nation: *But* it will remain a Truth, that *every Queen*, or *every King*, and *every Parliament*, succeeding the Present, that shall discover the *same Justice* in Government, the *same Care* in giving sufficient Funds, the *same Honesty* in supplying the Deficiencies if they happen, *the same Concern* for the Burthen of the Subject, and *the same Care* to put the Treasure into the Hands of Faithful and Experienc'd Officers; shall keep up *the same Character*, have *the same Credit*, and restore all these Declinings to *the same Vigour* and Magnitude, as ever. (1710, pp. 22-23)

novembre 2001. Paris : Institut de la gestion publique et du développement économique, Comité pour l'histoire économique et financière de la France, 2006.

⁵ See Carl Wennerlind, *Casualties of Credit: The English Financial Revolution, 1620-1720*, Cambridge, Mass.: Harvard University Press, 2011.

A number of other issues are also related to public credit: The openness and the publicity of the amount of public debt have been discussed early on. Necker's 1781 *Comptes rendu au roi* has been the acknowledgement that sound public finance cannot be a state secret (p. 3). The British notion of the budget was the model on which such accounts were based. Isaac de Pinto, a shrewd financier had pointed that out in his 1771 Treatise (p. 172) (see Grenier 2006, p. 6). The willingness of investors to acquire public debt and the rate of return which they were willing to accept depended upon their estimates on the default risk and this in turn depended upon the size of the existing (past) debt and the revenues of the state. Going public on this matter became necessary. The calculation of this risk was fraught with difficulties arising from the inherent uncertainties of these instruments and the probable assumption of more debt by the state if things did not go as expected in war. The democratization of public debt had added volatility to these estimates and made the management of expectations regarding public debt more necessary. The issue of trust – hence the honesty and probity – of the government became paramount, lest investors were lured into a trap that would have been lucrative *ex ante*, but disastrous *ex post*.

Even as early as the late 17th century political economists were discussing public debt as an alternative means for financing public expenses, especially extraordinary expenses, like those of war. Charles Davenant (1701) recruiting the new science of Political Arithmetic for this purpose distinguished the three possible means of finance (a) taxes, (b) debt and (c) sinking funds.⁶

Certain themes emerged also in this period. Was public debt of the same nature as that incurred by a private person? Since public debt creates bonds that are readily convertible in money and thus do not detract from the existing capital stock, is it the case that public debt – possibly within reason – is a panacea that can solve the problem of public finance? Or, on the contrary, is it a folly that has to be resisted at all costs? The political economy of public credit was being created at the same time with its object of analysis, following in the steps of the creation of paper currency and the financial revolution that it entailed.

⁶ [Charles Davenant], *An Essay upon Ways and Means of Supplying the War. The third edition*, London: Jacob Tonson, 1701. 1st edition 1695. On Davenant and other authors of the period on public debt see Matsushita, *The Economic Effects of Public Debts*, 1929, *op. cit.*, pp. 13-19.

Charles Davenant, the foremost political arithmeticians of his time after the death of Sir William Petty, was less mystified than Defoe. Writing at the end of the 17th century, he saw public debt incurred to finance war as part of the logistics of the war effort. In the same way that Fabius Maximus (cunctator) defeated Hannibal by correcting anticipating that logistics was on his side, so Britain could defeat France by creating a sinking fund that could scare Louis XIV away. This, however, could only happen if the fundamentals – in today’s parlance – were correct. If Louis saw that the creation of such a fund would be beyond the means of the nation creating it would have no effect. On the other hand, since taxes to finance extraordinary expenses were too high, a public loan would be the best way to dissipate the impact of these taxes. Maybe there would be more room to borrow more. There is, however, an end to these possibilities. Interest and repayment had to be financed through future taxes and this could create public outrage. (1698, 1701).

Of those who saw in public debt as beneficial to the economy was Jean-François Melon (1675-1738) a secretary of John Law, whose revamping of the system of public finances in France ended in disaster. Melon introduced a phrase that will mark later discussion and would make him the whipping boy of fiscal conservatives from Smith, Ricardo and Say to James Buchanan. His *Essai politique sur le commerce* was published in 1734, followed by two more editions in 1735 and 1736. It has been translated into English in 1738.⁷ Melon in the chapter *Du crédit publique* writes: “The Debts of a State are Debts due from the right Hand to the left, whereby the Body will not find it self weakened, if it hath the necessary Quantity of Aliments, and they are properly distributed” (1738, p. 329).⁸ The metaphor of the two hands became a point of reference for subsequent discussions on public debt.⁹ Further down Melon (1736, pp. 304-5; 1738, p. 337) notes that “It is to this Credit that the Republicks owe their Wealth and their Power. Let them be compared with Naples, Sicily and other

⁷ *A Political Essay Upon Commerce, Written in French by Monsieur M***, Translated with some Annotations and Remarks, by David Bindon, Esq.*, Dublin, Philip Crampton, 1738.

⁸ [Jean-François Melon], *Essai politique sur le commerce*, [s.l., s.n], 1736 p. 296. « Les Dettes d'un Etat sont des Dettes de la main droite à la main gauche, dont le corps ne se trouvera point affoibli, s'il a la quantité d'alimens nécessaires, & s'il sçait les distribuer ». On John Law see Antoin E. Murphy, « John Law et la gestion de la dette publique », in Jean Andreau, Gérard Béaur & Jean-Yves Grenier, (dir.), *La dette publique dans l'histoire* : « Les Journées du Centre de Recherches Historiques » des 26, 27 et 28 novembre 2001. Nouvelle édition [en ligne]. Paris, Institut de la gestion publique et du développement économique, 2006 pp. 269-296. His older magisterial treatment of the subject is *John Law: Economic Theorist and Policy-Maker*, Oxford: Clarendon Press, 1997.

⁹ On the hands metaphor see also Charles Davenant, 1701, pp. 29-30.

fertile Countries, where the want of sufficient Circulation, leaves the Inhabitants in continual Misery”. This is the view that a large public debt goes together with opulence. Melon, however, stops short of the idea that the size of public debt can be unlimited. Oddly enough, more than two centuries later, in the 1960s one of the most fiscal conservatives, James Buchanan, will make the same remark, namely that a large public debt is a sign that a state’s economy is strong, even though he is quick in pointing out that the reverse does not happen: an increase in public debt does not imply a stronger economy.¹⁰

Melon’s more famous compatriot, Baron Montesquieu, in the *Spirit of the Laws* (1748) thinks that the public debt has only disadvantages and no advantages. If it is in the hands of foreigners, it is they who profit from the interest payments by the state, while the taxation that is necessary to repay the debt harms industry and transfers income from those who are productive to the idle.¹¹ George Berkeley, on the other hand, in his *Querist* (1750) poses his queries in a way that shows that he considers public debt as a goldmine.¹² In the same year with Montesquieu an anonymous author across the Channel disagrees:¹³

If Sixty Millions of it [i.e., the public debt that is held by Britons] be the *Property* of the People of *Great-Britain*, it seems to me very plain that we are not the *richer* nor the *poorer* for that part of the *Debt*; because, if the Taxes be collected from the People of *Great-Britain*, the Money arising from those taxes, is paid to the Proprietors of the *Public Funds* in Dividends, or Interest, which circulating again, to purchase the Necessaries and Superfluities of Life, enables the *Farmer* to pay his *Rent*, the *Landlord* his *Taxes*; helps to support the *Industrious*, and to consume the Produce of their *Labour*.

The stark criticism to Melon’s argument comes from the great philosopher of the Scottish Enlightenment David Hume (1711–1776). In his essay “Of Public Credit” in

¹⁰ James M. Buchanan, “Debt, Public”, *International Encyclopedia of the Social Sciences*, vol. 4, London, Macmillan, 1968, pp. 28-34. Reprinted in James M. Buchanan, *Collected Works*, vol. 14, *Debt and Taxes*, Indianapolis, Liberty Fund, 2000, pp. 343-356.

¹¹ Montesquieu, *De l’esprit des lois*, Paris, Pierre Didot, l’aîné et Firmin Didot, édition stéréotype, An XII (1803), livre XXII, ch. XVII.

¹² George Berkeley, Bishop of Cloyne, *The Querist, containing, several queries, proposed to the consideration of the public*, London, W. Innys, C. Davis, C. Hitch and W. Bowyer, 1750, Queries 232-236. This is the second edition in which the most important queries on public debt have been added.

¹³ *An Essay on Publick Credit in a Letter to a Friend, Occasioned by the Fall of Stocks*, London, H. Carpenter, 1748, p. 8.

the second edition of *Political Discourses* published in 1752 attacks public credit.¹⁴ Hume admits that the creation of public debt ends up in bonds which function as a substitute for money, as long as they are freely negotiable and without risk of default. This increases the liquidity of trade. On the other hand, public credit causes “a mighty confluence of people and riches to the capital” (p. 130) and have all the disadvantages of paper credit. “The taxes, which are levy’d to pay the interests of these debts, are a check upon industry, heighten the price of labour, and are an oppression of the poorer sort. ... As foreigners possess a share of our national funds, they render the public, in a manner, tributary to them, and may in time occasion the transport of our people and our industry”. Finally, “The greatest part of public stock being always in the hands of idle people, who live on their revenue, our funds give great encouragement to an useless and inactive life”. (p. 131).

Hume believes that at some point the gradual increase of debt will increasingly mortgage the existing taxes and it will lead to devise even more onerous taxes. This eventually will lead to default, which would have destroyed bondholders in favour of citizens. But in fact those who would decide upon such a default would prefer to benefit the bond holders instead of the citizens. Eventually “It must, indeed, be one of these two events; either the nation must destroy public credit, or public credit will destroy the nation. ’Tis impossible they can both subsist, after the manner they have been hitherto manag’d, in this, as well as in some other nations” (p. 135).

Indeed, Hume’s hostility towards public debt is expressed with extreme vehemence in the following footnote in his *History of England* written at the end of his life in which he compares the Crusades to Public Debt:

For, I suppose, there is no mathematical, still less an arithmetical demonstration, that the road to the Holy Land was not the road to Paradise, as there is, that the endless encrease of national debts is the direct road to national ruin. But having now compleatly reached that goal, it is needless at present to reflect on the past. It will be found in the present year, 1776, that all the revenues of this island, north of Trent and

¹⁴ David Hume, “Discourse VIII: Of Public Credit”, in *Political Discourses, the second edition*, Edinburgh, R. Fleming for A. Kincaid and A. Donaldson, 1752, pp. 123-141. On Hume’s views on public credit see Istvan Hont, “The Rhapsody of the Public Debt: David Hume and Voluntary State Bankruptcy,” in Nicholas Philipson (ed.), *Political Discourse in Early Modern Britain*, Cambridge: Cambridge University Press, 1993, pp. 321-348 and J.G.A. Pocock, “Hume and the American Revolution: The Dying Thoughts of a North Briton”, in his *Virtue, Commerce and History: Essays on Political Thought and History, Chiefly in the Eighteenth Century*, Cambridge: Cambridge University Press, 1985, pp. 125-41.

west of Reading, are mortgaged or anticipated for ever. Could the small remainder be in a worse condition, were those provinces seized by Austria and Prussia? There is only this difference, that some event might happen in Europe, which would oblige these great monarchs to disgorge their acquisitions. But no imagination can figure a situation, which will induce our creditors to relinquish their claims, or the public to seize their revenues. So egregious indeed has been our folly, that we have even lost all title to compassion, in the numberless calamities that are waiting us.¹⁵

Among those who support the practice of public credit is Isaac de Pinto (1715-1787), an active member of Amsterdam's financial community with a thorough knowledge of the technical details of financial markets. He expresses his views in his book *Traité de la circulation et du crédit*, (Amsterdam, Marc Michel Rey, 1771) that has been translated into English in 1774.¹⁶ de Pinto despite his admiration for Hume insists that public debt not only burdens the state but that it creates extra money which is being productively invested. His text is perhaps one of the most complex of the period written by a man actively involved in stocks and bonds trading.¹⁷

A staunch supporter of the benefits of public debt was the first Secretary of the Treasury of the United States, Alexander Hamilton (1755-1804). He produced the Report on Public Credit to the Congress in 1790. Hamilton's views on public credit were expressed succinctly in a long letter to Robert Morris on 30/4/1781. In it he states that "A national debt, if it is not excessive, will be to us a national blessing. It will be a powerful cement of our Union. It will also create a necessity for keeping up taxation to a degree which, without being oppressive, will be' a spur to industry, remote as we are from Europe, and shall be from danger. It were other wise to be feared our popular maxims would incline us to too great parsimony and

¹⁵ David Hume, *The History of England from the Invasion of Julius Caesar to the Revolution in 1688*, Indianapolis, Liberty Fund, 1983, Vol. 4, Appendix III, p. 373, footnote c. The edition used was that of 1778.

¹⁶ *An essay on circulation and credit, in four parts; and a letter on the jealousy of commerce*, London, J. Ridley, 1774.

¹⁷ Pinto had a great admiration for Hume and he was disappointed to see him disagree with his views. He had not read Hume's essay on public credit when he wrote his own treatise and in the English translation he comments on the matter. For Pinto and his relation to Hume, and his criticism by Adam Smith and Karl Marx see Richard H. Popkin, "Hume and Isaac de Pinto", *Texas Studies in Literature and Language*, 12 (3) (Fall 1970), pp. 417-430. Marx called Pinto "The Pindar of the Amsterdam Stock Exchange" (1976, p. 251). Even though Hume thought highly of Pinto, there is no indication that he was moved from his views.

indulgence.”¹⁸ In a manuscript written after his resignation from the post of the Secretary of the Treasury in 1795 “In defence of the funding system” he writes even more explicitly:¹⁹

Trace the progress of a public debt in a particular case.

The government borrows of an individual one hundred dollars in specie, for which it gives its funded bonds. These hundred dollars are expended on some branch of the public service. It is evident they are not annihilated; they only pass from the individual who lent, to the individual or individuals to whom the government has disbursed them. They continue, in the hands of their new masters, to perform their usual functions, as capital. But besides this, the lender has the bonds of the government for the sum lent. These from their negotiable and easily vendible nature, can at any moment be applied by him to any useful or profitable undertaking which occurs; and thus the credit of the government produces a new and additional capital, equal to one hundred dollars, which, with the equivalent for the interest on that sum, temporarily diverted from other employments while passing into and out of the public coffers, continues its instrumentality as a capital, while it remains not re-imbursed.

On the other side of the Atlantic, Adam Smith discussed public debt in the final chapter of his *Wealth of Nations* (1776/1976, V.III, “Of Publick Debts”).²⁰ His tone is extremely hostile. He notes that “The progress of the enormous debts which at present oppress, and will in the long-run probably ruin, all the great nations of Europe, has been pretty uniform” (V.III.§10 p. 911). He combines economic analysis with history and empirical data to the last farthing. He acknowledges that the possibility of public debt is the result of the institutions of a commercial society where there is available capital and its citizens trust their government. He thinks, however, like most of the economists of his time that public debt is assumed mainly to finance wars and examines whether wars should be financed through taxes or loans. The problem with taxes is that it is extremely difficult to be collected at the sum required in a time of need, even though – on the other hand – taxes would make governments to think twice before going into war, which in the case of Britain would have no other consequence for her citizens but the financial burden. Moreover, part of the taxes

¹⁸ Alexander Hamilton, “Letter to Robert Morris, April 30, 1781”, in John C. Hamilton (ed.), *The Works of Alexander Hamilton*, vol. 1, New York, John F. Trow, 1850, 223-257, at p. 257.

¹⁹ Alexander Hamilton, “Defence of the Funding System”, in Henry Cabot Lodge (ed.), *The Works of Alexander Hamilton*, New York and London: G. P. Putnam's Sons, [1904], pp. 429-467, at pp. 460-461.

²⁰ Adam Smith, *An Inquiry Into the Nature and Causes of the Wealth of Nations*, Vol. I and II, ed. R.H. Campbell and A. S. Skinner, vol. II of the *Glasgow Edition of the Works and Correspondence of Adam Smith*, Oxford, Oxford University Press 1976. See also J. S. Nicholson, “Adam Smith on Public Debts”, *Economic Journal*, 30 (117) (March 1920), pp. 1-12.

comes from capital that has not been invested in productive uses, in which case the impact on productivity is smaller. In the case of loans, lenders are not burdened since they can loan their capital and at the same time they hold assets that are liquid. The real stock of the economy is, however, given and the extra capital in the hands of the lenders makes it possible to channel productive capital into non-productive uses. Smith is mindful of the creation of a fund financed by taxes in peace time that can be used at a time of war, since he does not trust the governments to put it into good use. On the other hand, he thinks that the ease with which governments can borrow money and transfer the burden to future generations combined with the difficulty of imposing new taxes may eventually lead to economic disaster and inability to service the debt which will lead either to devaluation of the currency or to bankruptcy. The taxes that the government will have to impose either to repay or service the debt – in the case of perpetuities – will fall either on the landlords who will not be able to spend the necessary amounts to maintain and improve the productive structures of agriculture, or on the capitalists who will see the returns on their capital to fall and who will transfer their activities abroad. Smith writes with infinite contempt about the non-productive bondholders and especially the French tax farmers who consumed by greed and conceit remain single since they will not marry women from their station, while honest women from the upper class despise them (1776/1976, V.III.§36 p. 919).

The disaster foretold by Hume and Smith did not arrive, in Britain at least. Smith, of course, notes his surprise that “Great Britain seems to support with ease, a burden which, half a century ago, nobody believed her capable of supporting.” He thinks, however, that this is as far as we can go: “Let us not, however, upon this account rashly conclude that she is capable of supporting any burden; nor even be too confident that she could support, without great distress, a burden a little greater than what has already been laid upon her” (1776/1976, V.III.§58 p. 929).

And yet, public debt keeps increasing without any problems for the country. A century after the Baron de Montesquieu, Thomas Babington Macaulay²¹ can be sarcastic:

²¹ Thomas Babington Macaulay, *The History of England from the Accession of James II*, Vol. IV, Philadelphia, Porter & Coates, [1848/1887?], p. 400

Here it is sufficient to say that the prophets of evil were under a double delusion. They erroneously imagined that there was an exact analogy between the case of an individual who is in debt to another individual and the case of a society which is in debt to a part of itself; and this analogy led them into endless mistakes about the effect of the system of funding. They were under an error not less serious touching the resources of the country. They made no allowance for the effect produced by the incessant progress of every experimental science, and by the incessant efforts of every man to get on in life. They saw that the debt grew; and they forgot that other things grew as well as the debt.

The debate on public debt is kept alive with those who support the creation of public debt to face the resistance of classical economists. The debate is of course not without an economic stake. Lenders of the State, the financial system with its secondary markets had a lot to gain from the process, while politicians could finance wars without imposing unpopular taxes in the same period. To the extent that GDP growth allowed servicing national debt there was no problem. Since we do not have GDP data – a concept that will be created in the 20th century – the Debt/GDP ratio that is central in current discussions on debt did not exist at the time.²² Nevertheless, there was a sense of the order of magnitude of debt sustainability. Jeremy Bentham (1748-1832) in his *Manual of Political Economy* written at the end of the 18th century, thinks that debt compounded at 2% will be doubled in about 35 years [the Lucas rule ante literam], which he writes does not happen with the incomes of the citizens even if we take account of the increase in population.²³ Moreover, he notes it is only the rich who see their incomes to rise, while the poorer half if anything see their incomes falling. In this period we have the first mathematical treatments of the Public Debt.²⁴

The initial remark by Smith that capital borrowed or taxed by the state is capital that is lost from the production process is the major argument of the orthodox economists of the period. It was, however, Jean-Baptiste Say (1767-1832) who had the greatest impact among economists for the first half of the 19th century and whose works have

²² Given enough imagination, however, we can calculate ex post GDP for times that data did not exist. Michael Wickens, for example, provides data for the Debt/GDP ratio for the USA and UK, from 1695 to 2010. Michael Wickens, *Macroeconomic Theory: A Dynamic General Equilibrium Approach*, Princeton and Oxford, Princeton University Press, 2011, 2nd edition, Figure 5.2 at p. 101.

²³ Jeremy Bentham, *Manual of Political Economy now first edited from the MSS of Jeremy Bentham*, in *The Works of Jeremy Bentham, published under the Superintendence of his Executor, John Bowring*, Edinburgh, William Tait, 1838-1843, 11 vols. Vol. 3, pp. 33-84 at p. 82.

²⁴ [Samuel Gale], *An Essay on the Nature and Principles of Public Credit*, London, B. White, 1784.

been translated in most European languages.²⁵ His *Traité d'économie politique* first published in 1803 went through six editions, the last one posthumously (1841). In the *Traité*, as in the *Wealth of Nations*, public debt is treated in the last chapter.²⁶ According to Say the difference between a private individual who borrows money and a state that incurs debt is that the individual borrows money for a productive cause, while the state does not. Hence, public debt detracts productive capital from the economy and only in the case where the state borrows from capital that would have remained unproductive in order to make productive investments public debt make sense. This argument will constitute the orthodox position on the matter. Those who believe that public debt is a cause of prosperity are attacked by the orthodox view.²⁷

It is David Ricardo (1772-1823) who famously enters the discussion. First in his *Principles* [1817] and in his article on the “Funding System” published in the Supplement to the Fourth, Fifth and Sixth Editions of the *Encyclopaedia Britannica* in 1820.²⁸ We also have numerous discussions on financing public debt in his speeches in the Parliament²⁹ and in his letters.³⁰ Ricardo follows the classical argument, quoting approvingly from Jean-Baptiste Say. He generally thinks that public expenditure should be as limited as possible. He observes, however, as an economist that – under certain assumptions – it is indifferent if expenditure is financed through

²⁵ For the importance of Say, see Keith Tribe, (2003) “Continental Political Economy from the Physiocrats to the Marginal Revolution”, in Th.M. Porter & D. Ross (eds), *The Cambridge History of Science*, Volume 7: *The Modern Social Sciences*, Cambridge, Cambridge University Press, pp. 154-170, at p. 162.

²⁶ Jean-Baptiste Say, *Traité d'économie politique, ou, Simple exposition de la manière dont se forment, se distribuent et se consomment les richesses*, Paris, Rapilly, 1826 [5ème édition], livre 3^{ème}, Chapitre XI « De la Dette Publique ».

²⁷ See for example the debate between William Spence and James Mill: William Spence, *Britain independent of commerce: or, proofs deduced from an investigation into the true causes of the wealth of nations...*, London, T. Cadell & W. Davies, 1807, 2nd edition. James Mill, *Commerce defended. An answer to the arguments by which Mr. Spence, Mr. Cobbett, and others ...*, London, C. and R. Baldwin, 1808, 2nd edition. Even more interesting are the views of Nicolas-François Canard, (1754-1833) in his *Principes d'économie politique*, (Paris : F. Buisson, 1801) where he speaks in favour of public debt and speaks against what will be later called Ricardian equivalence, since the citizen, if a tax were imposed, he had to borrow that money at worse terms (1801, p. 205).

²⁸ David Ricardo, *The Works and Correspondence of David Ricardo*, ed. Piero Sraffa with the Collaboration of M.H. Dobb, Cambridge, Cambridge University Press, 1951-73, Vol. 1 *On the Principles of Political Economy and Taxation* [1st edition 1817, 2nd edition 1819, 3rd edition 1821, London, John Murray] and as E.E.E., “Funding System”, An Article in the Supplement to the Fourth, Fifth and Sixth Editions of the *Encyclopaedia Britannica*, 1820, Vol. 4 *Pamphlets and Papers 1815-1823*, pp. 143-200.

²⁹ *The Works and Correspondence ...*, Vol. 5 *Speeches and Evidence* [1819].

³⁰ Especially to John Ramsay McCulloch and to Hutches Trower. See R. O. Roberts, “Ricardo's Theory of Public Debts”, *Economica*, New Series, 9 (35) (1942), pp. 257-266 for an excellent discussion on Ricardo's views on the matter.

debt or taxation. If the state chooses to tax in order to cover the expenditure, then the citizen can always get a loan for the equivalent amount that is levied as tax.³¹ He is clear, however, that even though there is no difference in principle, he does not support the practice of debt since “It is a system which tends to make us less thrifty—to blind us to our real situation” [p. 247]. In his article on the “Funding System” he describes three different ways of financing a hypothetical expenditure of 20 million pounds for war purposes: (1) direct financing through taxation, (2) borrowing without ever repaying the principal at an annual payment of one million in interest, assuming an interest of five *per cent.* and (3) the creation of a fund in which extra revenues will be paid and which will be compounded until it will reach the amount 20 million pounds that will repay the principal. From the three systems, Ricardo clearly prefers the first. He writes: “*In point of economy, there is no real difference in either of the modes; for twenty millions in one payment, one million per annum for ever, or 1,200,000l. for 45 years, are precisely of the same value; but the people who pay the taxes never so estimate them, and therefore do not manage their private affairs accordingly*” [1820, p. 187, my italics]. Ricardo is clearly against public debt. He argues that there is, what later will be called “public debt illusion”, i.e., that people tend to think that it is less onerous to pay taxes to service debt in perpetuity than to pay the whole expenditure in a lump sum. He does not think improbable that capitalists will transfer their funds abroad if they are to stay in a country that will keep taxing them to pay for the interest of the public debt. He also thinks necessary to repay in peace time debt that has been assumed in order to finance war. In his parliamentary speeches he harbours no illusions about the creation of sinking funds which accumulate money to repay debts, but in reality end up as mechanisms to accumulate more debt.

In subsequent literature this conditional “theorem” by Ricardo regarding the equivalence between taxes and debt has been dubbed “Ricardian equivalence” by James Buchanan.³² It is, of course, a misnomer since Ricardo never thought that the

³¹ *On the Principles of Political Economy and Taxation*, Chapter XVII, pp. 244-6.

³² James Buchanan, “Barro on the Ricardian Equivalence Theorem”, *Journal of Political Economy*, 1976, 84 (2), pp. 337-342. See, Andrew B. Abel, “Ricardian equivalence theorem”, in J. Eatwell, M. Milgate & P. Newman (eds), *The New Palgrave: A Dictionary of Economics*, London, Macmillan, 1987, vol. 4, pp.174-179.

two were equivalent.³³ The term “Ricardian equivalence” and the subsequent discussion started in a totally different context in the 1970s when Robert Barro in his article in the *Journal of Political Economy* wanted to maintain the validity of the theorem even when tax payers might die before the debt is repaid.³⁴ Barro assumed that tax payers are altruistic and that they want to leave their inheritance to their descendants. Essentially, he turned them into infinitely lived agents, discussing the case of overlapping generation. His main purpose was to prove the par excellence anti-Keynesian position that fiscal expenditure has no impact since citizens discount the fact that tax will eventually be paid. James Buchanan, discussing Barro’s paper notes Ricardo’s contribution and coins the “theorem”.

More cautious in the matter of debt is Ricardo’s friend and rival Thomas Robert Malthus (1766-1834). His “effectual consumption” and the “doctrine of proportions” – i.e., the denial of Say’s Law – a fact that made him so dear to John Maynard Keynes, makes him to see the role of non-productive workers at the service of rich people, soldiers, sailors, landowners and holders of public debt in a different perspective. It is they who subsist on taxes without producing themselves, but who create the necessary consumption so that the economy can achieve full employment. Public debt helps their maintenance. On the other hand, Malthus innate conservatism makes him to see the disastrous results that a large public debt can bring about, which – at any rate – are less disastrous than those that Poor Laws can lead to, and proposes to examine the whole issue in such a manner as to find the golden mean so that the public debt is not increased. An increase in public debt must be financed by taxes which if they are exorbitant they will affect adversely production, will lead to the devaluation of currency which is unfair to bondholders and, perish the thought, it might create the impression that the state is unable to honour its obligations which

³³ Gerald P. O’Driscoll, Jr, “The Ricardian Nonequivalence Theorem”, *Journal of Political Economy*, 1977, 85 (1), pp. 207-210, Willem Hendrik Buiter & James Tobin, “Debt Neutrality: A Brief Review of Doctrine and Evidence”, Cowles Foundation Discussion Paper No 497, 1978, reprinted in George M. Von Furstenberg (ed.), *Social Security versus Private Saving*, Cambridge, Mass., Ballinger Publishing, 1979, pp. 39-63, Lefteris Tsoulfidis, “Classical Economists and Public Debt”, *International Review of Economics*, 2007, 54 (1), pp. 1-12.

³⁴ Robert J. Barro, “Are government bonds net wealth?”, *Journal of Political Economy*, 1974, 82 (6), pp. 1095-1117.

will cast a shadow of doubt on the credibility of the state and insecurity of those who have property.³⁵

John Stuart Mill's (1806-1873) *Principles of Political Economy* was a landmark text in economics. Published in 1848 it went through six more editions before Mill's death. For half a century it served as the major textbook in economics. Mill attacks public lending arguing that it is worse than taxes. [see his discussion Chalmers] Taxes on capital end up in hurting the working classes since the fund available for the productive employment of labour is given. It is the infamous theory of the Wages Fund. For Mill lending exacerbates the problem:

Whenever capital is withdrawn from production, or from the fund destined for production, to be lent to the State, and expended unproductively, that whole sum is withheld from the labouring classes: the loan, therefore, is in truth paid off the same year; the whole of the sacrifice necessary for paying it off is actually made: only it is paid to the wrong persons, and therefore does not extinguish the claim; and paid by the very worst of taxes, a tax exclusively on the labouring class. And after having, in this most painful and unjust way, gone through the whole effort necessary for extinguishing the debt, the country remains charged with it, and with the payment of its interest in perpetuity.³⁶

Nevertheless, he admits exceptions. In the chapter on National Debt (Book V, Chapter vii, Of a "National Debt") he specifies that "there are other circumstances in which loans are not chargeable with these pernicious consequences: namely, first, when what is borrowed is foreign capital, the overflowings of the general accumulation of the world; or, secondly, when it is capital which either would not have been saved at all unless this mode of investment had been open to it, or after being saved, would have been wasted in unproductive enterprises, or sent to seek employment in foreign countries".³⁷ The litmus test of whether borrowing is made from foreign or unproductive capital is a rise in the interest rate. If the interest rate remains the same this means that public borrowing has no negative impact.

³⁵ Thomas Robert Malthus, *Principles of Political Economy*, London, W. Pickering, 1836, 2nd edition, pp. 411-413 (II.IX) It was published posthumously from Malthus' manuscripts. These remarks are absent in the 1st edition.

³⁶ John Stuart Mill, *The Collected Works of John Stuart Mill*, Volume II, *The Principles of Political Economy with Some of Their Applications to Social Philosophy (Books I-II)*, ed. John M. Robson, introduction by V.W. Bladen, Toronto: University of Toronto Press, London: Routledge and Kegan Paul, 1965 at p. 77 (I,v,§ 8).

³⁷ Volume III, Books III-V, p. 874.

Otherwise, public debt and private capital are in competition, interest rate rises and workers pay the cost.³⁸

By the end of 19th century and in the beginning of the 20th the orthodoxy on public debt has been consolidated. In the Anglo-Saxon and French-speaking academia the major textbooks on public finance are almost sarcastic about the deluded notions of the 18th century and explain why it is better to finance through taxation even extraordinary and unforeseen expenses at the time in which they are incurred. This is obvious in the textbooks by Charles Francis Bastable (1855–1945) and Paul Leroy-Beaulieu (1843-1916) who write with an air of authority on the matter.³⁹ There is, of course, a pragmatic approach in these authors. Public debt is here to stay. It is the bad management of it that is being condemned. The climate is different in countries where pragmatism reins on the matter of public debt. In Germany the initial cameralism of 18th century with Justi, cedes its place in the first half of the 19th century to theoreticians who view public debt as a necessary evil, while in the second half of the century we have theories which view public debt in a positive manner.⁴⁰ The usual culprits here are Dietzel and Wagner, and to a lesser extent Nebenius. Italian economists, even though they are liberal, take no hostile view on the matter. Antonio De Viti de Marco (1858-1943) in particular extends the theorem of Ricardian equivalence.⁴¹

The situation changes drastically after the Great Depression on 1929, the New Deal and the Second World War.

Public expenditure as a means of achieving full employment is now acceptable and deficit financing has a following. This difference is to a large extent the work of John

³⁸ See Lefteris Tsoulfidis, “Public Debt and J.S. Mill’s Conjecture: A Note”, *History of Economic Thought and Policy*, vol. 2013 (2), pp. 93-102, for an empirical testing of this hypothesis.

³⁹ C. F. Bastable, *Public Finance*, London, Macmillan. 1st edition 1892, 2nd 1895, 3rd 1932. Book V, Chapter V. “The Theory of Public Credit and Public Debts”. Paul Leroy-Beaulieu, *Traité de la science des finances*, Paris, Guillaumin 1877, 1st edition. 5th edition in 1892 in two volumes, while the 8th edition by Félix Alcan appeared in 1912. More than 450 pages of the second volume are dedicated to the issue of Public Debt. The Chapter on the impact of public debt is the 3rd chapter of the 2nd book of the 2nd volume in the 7th edition of 1906.

⁴⁰ See in particular Gustav Cohn, *The Science of Finance*, Chicago, University of Chicago Press 1895 in Thorstein Veblen’s translation, § 508 *et seq.*

⁴¹ A. De Viti De Marco, “La pressione tributaria dell’imposta e del prestito”, *Giornale degli Economisti*, serie seconda, Vol. 6 (year 4), (January 1893), pp. 38-67. James M. Buchanan, *The Collected Works of James M. Buchanan*, vol. 2. *Public Principles of Public Debt: A Defense and Restatement*, Indianapolis, Liberty Fund, 1999 [1958], “Appendix: Public Loans versus Extraordinary Taxes: The Italian Debate”, pp. 88-94.

Maynard Keynes who showed the possibility of unemployment equilibrium and the role of fiscal policy in achieving full employment. Keynes himself was a realist and saw that a country cannot keep up an increasing large public debt since this was not politically feasible. The younger generation of Keynesians had no such qualms. In the USA Alvin Hansen demonstrated that the size of public debt matters only in relation to the national income. Evsey Domar in his article in the *American Economic Review* in 1944 constructed a mathematical model showing that under certain conditions public debt can be continuously increasing but the proportion of taxes required to make it sustainable can remain constant. There is no problem with Deficit Financing as long as there is a sustainable growth of the economy.⁴²

Even more radical in his views on public debt was Abba P. Lerner with his theory of Functional Finance.⁴³ According to Lerner the size of the Public Debt in absolute or relative numbers is immaterial, as is the level of taxes and the money printed by the government. The only thing that matters is to maintain the level of the national income to the level of full capacity and full employment without inflation. The government should do whatever it takes to achieve this without caring about the existence of budget deficits or the size of the national debt. Anything else is immaterial and reflects the scholasticism of doctrines of bygone eras. Lerner's views proved to be too radical even for Keynes himself who condemned them in public. The problem was not that Lerner's views were inconsistent with Keynesian theory. They were logically sound within Keynes' theory and they were pushing the theory to its logical conclusions. Keynes feared that an increase in National Debt was not politically sustainable. At a certain point the Debt/GDP ratio will reach a level that would have created a confidence crisis for the government.⁴⁴

Keynesian theories of demand management coexisted with the golden age of postwar world economy. The stagflation of the 1970s changes the scenery in economic theory. Monetarism first in the USA, then in the UK and then in the rest of the European countries condemns deficit financing and demand management. Already in 1958

⁴² Evsey D. Domar, "The "Burden of the Debt" and the National Income", *American Economic Review*, 34 (4) (Dec. 1944), pp. 798-827, where the references to Alvin Hansen.

⁴³ Abba P. Lerner, "Functional Finance and the Federal Debt", *Social Research*, 10 (1), (Feb. 1943), pp. 38-51.

⁴⁴ See the extremely interesting article by Tony Aspromourgos "Keynes, Lerner, and the Question of Public Debt", *History of Political Economy*, 46 (3), pp. 409-433.

James Buchanan lambasts what he calls the “new orthodoxy” regarding public debt.⁴⁵ The new macroeconomic theory is transformed into microeconomics in search of microfoundations and attempts to derive policy conclusion. In this brave new world, rational agents inter-temporally maximize their utility over infinite lives and their rationality is not fooled by debt-financed fiscal measures. Economies are in equilibrium, unless there is an external shock or governments interfere. Balanced budgets and low public debts are derived now as scientific results of the new theory which should be incorporated – away from the madding crowd of politics and the will of electorates – into the constitutions of countries. Even though the ability of these theories to account for the possibility of global crises has been proven miserably inadequate, the analysis of public debt in the new political economy has served as the servant of reactionary neoliberal policy vying for ideological hegemony.⁴⁶

⁴⁵ James M. Buchanan, *Public Principles of Public Debt: A Defense and Restatement*, 1958. Reprinted as vol. 2, *The Collected Works of James M. Buchanan*, Indianapolis, Liberty Fund, 1999, Chapter 2.

⁴⁶ Take Greece as an example: All forecasts regarding the Debt/GDP ratio and GDP growth have been continuously revised, and the desired reduction of this ratio and GDP growth in every new report has been pushed to the future. *OECD Economic Surveys: Greece 2013*, OECD Publishing. [http://dx.doi.org/10.1787/eco_surveys-grc-2013-en], Figure 4. Official projections of Maastricht debt and nominal GDP, at p. 20.

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