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THE ECONOMIC EFFECTS OF PUBLIC DEBTS

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PREFACE

A DEBT of an individual is, in the ordinary sense, his obligation to pay in the future what he borrows in the present. Similarly, a public debt is a state's obligation to pay in the future what it borrows now. Thus considered, there appears to be no fundamental difference in nature between these two sorts of debt; but in truth there are several important differences between them. In the first place, unlike a private person, a state can coerce its people to lend, as it does when it issues paper money. This is known in public finance as " forced loan ". There is also the corollary that, unlike a private debtor, a state can repudiate its obligations. These differences arise from the sovereign nature of a state.[1] However, as the states become more and more democratic, and as the commercial spirit becomes even more powerful, these differences tend to become more and more potential rather than actual. In other words, the important modern states tend to conform in their debt treatment to private commercial rules. Only in times of emergencies do states deviate from this course.

In the second place, the purposes for which a state borrows may be quite intangible, and may not admit of measurable benefits, while we know that a normal private debt is incurred for the purpose of some enterprise which will yield the profit to pay the interest. Ordinarily, therefore, a mutual benefit is involved in a private borrowing. This is often not the case with a public borrowing. To quote Professor Daniels,

The payment of interest by the state to its bond-holders often,

[1] See H. C. Adams, *Science of Finance*, p. 520.

though not always, connotes, not a public benefit, but a public sacrifice. The state may be paying its creditors interest upon a loan of capital where the actual capital borrowed was destroyed years ago in prosecuting a war, or wasted outright in some industrial venture.[1]

Thus, the effect produced by a state's fulfillment of its debt obligations may be very different from that of an individual's.

Public debts as thus far described are mainly of two kinds: forced loans and public bonds. They are further divisible into treasury notes, legal-tender notes, short-term bonds, "perpetual" bonds, etc. It is the purpose of this dissertation to trace, as far as possible, the economic effects of the creation of these various forms of obligations, and of the various uses to which their proceeds are put. In any analysis of economic phenomena it is impossible to make any generalization or to draw any general conclusion without making some sort of an assumption. In the following pages, whenever any definite statement is made without express assumptions, it is implicitly based upon our economic phrase "other things being equal."

From ancient times the question of public debts has always been a thorny one; but never before in the history of nations has the subject been so important and so delicate as at present. The great World War of 1914-1918 played such untold havoc with the finances of the belligerent nations that they are still prostrated and are groaning under colossal debts. Recently in connection with the debt-settlement proposals of the United States to Great Britain and France, the question of public debts has become the pivotal point upon which turns international amity or discord. But the most important point of interest in our present subject is the

[1] W. M. Daniels, *Elements of Public Finance*, pp. 291-292.

tremendous economic effects of these heavy debts on the nations of the world for years to come. Since the purpose of this dissertation is in the main to make a theoretical analysis of the economic effects of public debts, we shall not deal in particular with the contemporary problems of public debts. We shall, however, as occasion may arise, touch upon a few of the problems of the time by way of illustration.

Due to many difficulties in obtaining rare historical books which were necessary to investigate for the writing of Chapter I, I am deeply indebted to the librarians of Columbia University Library and of New York City Library. But my greatest acknowledgment is due my teacher, Professor Edwin R. A. Seligman, who has first suggested the subject of this dissertation. Without his constant criticisms, helpful suggestions and untiring guidance, to say nothing of his allowing me to get access to his private library, this work would not have been completed. I am also very much indebted to Mr. Carl S. Shoup who has kindly read the entire manuscript and made helpful suggestions. My acknowledgment is due Mrs. C. A. Stewart of the Economics Department of Columbia University for the aid offered me in more ways than one in the course of the preparation of this dissertation. For the preparation of the last chapter, I am deeply indebted to Mr. Andrew Keogh of the Yale University Library, who has kindly allowed me while in New Haven to get access to the University Library. I am also indebted to Miss Anne G. Seery of West Haven for the final painstaking typing of the manuscript.

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CHAPTER I

HISTORY

To give a clear insight into the subject matter of the present discussion, a few words should be said here about the origin of public debts and the opinions of the more prominent writers of the past and the present concerning them. Says Bastable:

> To summarize . . . state borrowing appears to be, in its leading features, a creation of the constitutional period, built upon the decay of the older method of state hoarding and having its germs in the Middle Ages. It is the result of the credit system, combined with the increase of public expenses and the greater security for observance of faith to the state creditors.[1]

To this it may be added that the international wars with their stupendous costs have been the greatest single factor which has made the question of public debts such an important one. The growth of public debts the world over is clearly shown in the following figures:

Total national debts of the world (in approximate figures):[2]

1783	$2,530,000,000
1820	7,650,000,000
1848	8,650,000,000
1870	15,000,000,000
1885	23,000,000,000
1890	32,525,000,000
1900	35,000,000,000
1908	36,548,000,000[3]

[1] Bastable, *Public Finance* (3rd ed.), pp. 627-628.

[2] *Ibid.*, p. 626. Also Seligman, *Essays in Taxation* (1920 ed.), p. 757.

[3] From C. C. Plehn, *Introduction to Public Finance* (4th ed.), p. 340.

At the end of the World War it rose to the staggering sum of $210,000,000,000.[1]

Now, as to the opinions of some of the more distinguished writers of the past on public debts. Let us take them up in as nearly a chronological order as possible. One of the earliest writers in this field was *Jean Bodin* who wrote, in 1576, of the advantages that are derived from the royal expenditures upon public works. According to this writer, the royal expenditures themselves upon public works were unconditionally beneficial to the country:

For beyond the fact that such works are necessary, there result besides great benefits to the commonwealth; inasmuch as by this means the arts and artificers are supported, the poor are relieved, and dislike of taxes and duties is removed, when the Prince restores to the public at large and to individual subjects the money he takes from them.[2]

Nearly a century later (1667) we find *Sir William Petty* also speaking of the expenditures upon public works as in themselves beneficial to society because, among other things, public works give employment to the poor. Thus, with reference to the poor and ignorant element of society, whom he calls " supernumeraries," we find him saying,

Now as to the work of these supernumeraries, let it be without expense of Foreign Commodities, and then 'tis no matter if it be imployed to build a useless Pyramid upon Salisbury Plain, bringing the Stones at Stonehenge to Tower-hill, or the like; for at worst this would keep their minds to discipline and obedience, and their bodies to a patience of more profitable labours when need shall require it.[3]

[1] Seligman, *Essays in Taxation*, p. 757, Table C.

[2] From Bullock, *Selected Readings in Public Finance*, 2d ed., p. 22.

[3] Sir Wm. Petty, *A Treatise of Taxes and Contributions*, London, 1667, chap. ii, p. 13.

It is evident, in the light of our present knowledge of public expenditures, that these early writers based their opinions on public expenditures upon the erroneous mercantilistic conceptions of wealth and of production. They did not realize that unproductive public expenditures impoverish the country. On this point we shall dwell at length in a later chapter.

A few decades later we find another English writer, *Charles Davenant*, dealing with our immediate question of public debt. His discussion of public debt is subordinated to the question of taxation for war, as we can easily see from the title of his book, "An Essay upon Ways and Means of Supplying the War." His chief contention was that a heavy burden of interest payment was harmful to the country and that, therefore, a large debt was to be avoided. Of taxes to pay interests upon debts, he says: " For taxes of this nature beget public and private poverty, make the people desperate, render government uneasy to the rulers, and may be rather said to fight secretly against the prince, than to give him any assistance." [1] Against excessive utilization of public credit, Davenant had a sound idea, for we find him saying in another passage that " The fonds for interests were, perhaps, good expedients, for the time, to raise money, but, if made use of frequently, may produce very bad effects in the nation; for they divert money too much from the channel of trade, where it is always best employed to the kingdom's advantage." [2] Davenant also correctly emphasized the evil tendency of the public " fonds " to raise the rate of interest, to the detriment of all the merchants who worked on borrowed capital, and who are, perhaps, the most industrious people in the country.[3] Again, he deprecated the idle class of interest-receivers as "the true drones of a commonwealth,

[1] Davenant, *op. cit.*, p. 31.

[2] *Ibid.*, p. 42.

[3] *Ibid.*, pp. 43-44.

living upon the honey without any labour."[1] Throughout this essay, Davenant seems to favor a well-distributed taxation, instead of public loan, as the best of ways and means of meeting the cost of the war.

In his other little book, "A Discourse upon Grants and Resumptions" (1700), Davenant advocated the application of forfeited and resumed lands to the payment of public debts. His chief concerns were the dangers, on the one hand, of the country "being eaten up by that canker of usury," or, on the other, of misappropriation of the money assigned for interest payment by tyrannous princes or bad ministers. While today the credit of all the great nations of the world is generally so enhanced that the interest charged on public loans is no longer usurious as in the days of Davenant, still one of the strongest arguments in favor of the extinguishment of the public debt is that the perpetual payments of large sums of interest on account of the debt are very injurious to industry and demoralizing to the taxpayers. Of this we shall see more in the following chapter. As to the misappropriation of the money assigned for debt service, we still find the evil existing today in the frequent raiding of the sinking funds in local finances. Making due allowance for the change in conditions, we therefore find that what Davenant said over two hundred years ago is still true in a general way.

About this time we find a germ of argument against tax exemption of public bonds in the writing of *James Drake*. Drake complains of the iniquitous taxes of that time in England, and of their bad effects. He tells us that as long as husbandry, manufacture and trade paid 4*s*. to the pound in taxes, while money loaned to the government received eight per cent from the government, besides some other advantageous conditions, without paying anything to the support

[1] Davenant, *op. cit.*, p. 111.

of the government, " few that have money will be persuaded to employ it in Husbandry, Manufacture or Trade, or the encouragement of them at common interest or hazard." " By this means those three springs of all our Wealth and Power being destitute of recruits, must in a short time decay and prove quite deficient." [1] He concluded, therefore, that money wherever placed should be taxed just as much as any other property.

Drake thought that there were two ways to make the moneyed class share the burden to the same extent with " Land [2] or Labour, which have hitherto born the whole burden of the day ":

> Either by reducing the interest of Money Lent to the Government to such a rate, as may make the Lenders as fair contributors to the expenses of the Public, as if it were lent to any other person upon sufficient security. . . . Or by taking of it, according to its product in Interest, as it were so much a year in Land.[3]

Obviously the first is a compulsory reduction of interest which is unsound, and the second is a tax on interest on government loans, which is advocated today by the opponents of the tax-free bonds. Of this, more later. Drake erroneously thought, also, that the way to raise the Government credit to a par with the best private security is for the government to raise enough money every year by taxation to be able to pay both interest and principal of the sum borrowed for that year.[4] Finally, Drake mentions two objections which were made by many at that time against a tax on the

[1] James Drake, *An Essay Concerning the Necessity of Equal Taxes* (London, 1702), p. 3.

[2] By " Land " he means husbandry, manufacture and trade.

[3] *Ibid.*, pp. 10 *et seq.*

[4] *Ibid.*, pp. 5-6.

interest on government securities: (1) such a tax is a breach of contract, and (2) government credit will be destroyed by it. He answers ably as follows: Any contract, forced under necessity, which is unjust and unreasonable can be broken without violating justice. Furthermore, the continuance of a usurious interest and the consequent difficulty of the government in meeting it is far more destructive of public credit than the reducing of it and the subsequent punctual payment of the interest and the principal.[1]

One of the earliest English writers who specifically wrote on public credit was *Harley*. According to him, public credit is the result of honorable, just, and punctual management in the matter of funds and taxes, or loans upon them.

> This management depends not upon the Well-Executing their Offices, by the great Officers of the Treasury, and the Exchequer, but on the Care, Conduct and Vigilance of her Majesty and the Parliament; the latter in Establishing sufficient Funds; and the former in Placing able Officers, and obliging them to an honourable Management.[2]

Harley's view of public credit is similar to those of Nebenius and Rau, who wrote in the following century, and is true as far as he goes.[3] But, of course, objective as well as subjective elements must be included in a full analysis of credit.

In the beginning of the 18th century there were many writers who were apprehensive of the increasing national debt of England. *Archibald Hutcheson* was one of them. In his treatise "Computations relating to the Public Debts, April 11th, 1717,"[4] Hutcheson gives us detailed figures de-

[1] Drake, *op. cit.*, pp. 14-21.

[2] Harley, *An Essay upon Public Credit*, 1710, p. 13.

[3] On this point, see C. C. Plehn, *Introduction*, pp. 372-7.

[4] From, *A Collection of Treatises Relating to the Public Debt and the Discharge of the Same*, by Archibald Hutcheson, London, 1721.