# Is the National Debt an Scarecrow? A debate between Skidelsky and Reinheart

## The Scarecrow of National Debt

Robert Skidelsky

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CAMBRIDGE – Most people are more worried by government debt than about taxation. "But it's *trillions"* a friend of mine recently expostulated about the United Kingdom's national debt. He exaggerated a bit: it is £1.7 trillion ($2.2 trillion). But one website features a clock showing the debt growing at a rate of £5,170 per second. Although the tax take is far less, the UK government still collected a hefty £750 billion in taxes in the last fiscal year. The tax base grows by the second, too, but no clock shows that.

Many people think that, however depressing heavy taxes are, it is more *honest* for governments to raise them to pay for their spending than it is to incur debt. Borrowing strikes them as a way of taxing by stealth. "How are they going to pay it back?" my friend asked. "Think of the burden on our children and grandchildren."

I should say that my friend is extremely old. Horror of debt is particularly marked in the elderly, perhaps out of an ancient feeling that one should not meet one's maker with a negative balance sheet. I should also add that my friend is extremely well educated, and had, in fact, played a prominent role in public life. But public finance is a mystery to him: he just had the gut feeling that a national debt in the trillions and growing by £5,170 a second was a *very bad thing*.

One should not attribute this gut feeling to financial illiteracy. It has been receiving strong support from those supposedly well-versed in public finance, particularly since the economic collapse of 2008. Britain's national debt currently stands at 84% of GDP. This is dangerously near the threshold of 90% identified by Harvard economist Kenneth Rogoff (together with Carmen Reinhart and Vincent Reinhart), beyond which economic growth stalls.

In the face of criticism of the data underlying this threshold Rogoff has held firm, and he now gives a reason for his alarm. With US government debt running at 82% of GDP, the danger is of a "fast upward shift in interest rates." The "potentially massive" fiscal costs of this could well require "significant tax and spending adjustments" (economist's code for increasing taxes and reducing public spending), which would increase unemployment.

This is the financial leg of the familiar "crowding out" argument. The higher the national debt, according to this view, the greater the risk of government default – and therefore the higher the cost of fresh government borrowing. This in turn will raise the cost of new private-sector borrowing. (That is why Rogoff wants the US government to "lock in" currently low rates by issuing much longer-term debt to fund public infrastructure). Maintaining low interest rates for private bank loans has been one of the main arguments for reducing budget deficits.

But this argument – or set of arguments (there are different strands) – for fiscal austerity is invalid. A government that can issue debt in its own currency can easily keep interest rates low. The rates are bounded by concerns about inflation, over-expansion of the state sector, and the central bank's independence; but, with our relatively low levels of debt (Japan's debt amounts to over 230% of its GDP) and depressed output and inflation, these limits are quite distant in the UK and the US. And as the record bears out, continuous increases in both countries' national debt since the crash have been accompanied by a fall in the cost of government borrowing to near zero.

The other leg of the argument for reducing the national debt has to do with the "burden on future generations." US President Dwight Eisenhower expressed this thought succinctly in his State of the Union message in 1960: generating a surplus to pay back debt was a necessary "reduction on our children's inherited mortgage." The idea is that future generations would need to reduce their consumption in order to pay the taxes required to retire the outstanding debt: government deficits today "crowd out" the next generation's consumption.

Although governments have endlessly repeated this argument since the 2008 crash as a justification for fiscal tightening, the economist A. P. Lerner pointed out its fallacy years ago. The burden of reduced consumption to pay for government spending is actually borne by the generation which lends the government the money in the first place. This is crystal clear if the government simply raises the money it needs for its spending through taxes rather than borrowing it.

Furthermore, the idea that additional government spending, whether financed by taxation or borrowing, is bound to reduce private consumption by the same amount assumes that no flow of additional income results from the extra government spending – in other words, that the economy is already at full capacity. This has not been true of most countries since 2008.

But in the face of such weighty, if fallacious, testimony to the contrary, who am I to persuade my elderly friend to ignore his gut when it comes to thinking about the national debt?

## The Perils of Debt Complacency

Carmen Reinhart

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CAMBRIDGE – "What a government spends the public pays for. There is no such thing as an uncovered deficit." So said John Maynard Keynes in *A Tract on Monetary Reform*.

But Robert Skidelsky, the author of a magisterial three-volume biography of Keynes, disagrees. In a recent commentary entitled "The Scarecrow of National Debt," Skidelsky offered a rather patronizing narrative, in a tone usually reserved for young children and pets, about his aged, old-fashioned, and financially illiterate friend's baseless anxiety about the burden placed on future generations by the rising level of government debt.

If Skidelsky's point had been that some economies, including the United States, would benefit from higher infrastructure spending, even at the cost of more debt, I would agree wholeheartedly. Compelling reasons for boosting US public investment include deteriorating infrastructure, tepid growth, low interest rates, and limited scope for further monetary stimulus. For the US, such an impetus might be especially welcome as the Federal Reserve raises interest rates (albeit gradually) while other countries ease further or hold rates steady and the dollar likely strengthens.

But that was not the route Skidelsky took. Instead, in his critique of a commentary by Kenneth Rogoff, he argued that it is silly and passé for a country that can issue debt in its own currency to fret over medium-term debt levels. Call me old-fashioned, but that argument smacks of complacency and is not supported by evidence. On this score, Skidelsky confuses two different papers on debt and growth, a 2012 paper of mine, in which there were some alleged data concerns, with one that I co-authored with Rogoff and Vincent Reinhart, in which there were none.

Coming from an author who knows Keynes so well, such complacency disappoints. I cannot read *How to Pay For the War* and conclude that Keynes thought that high war debts were a "scarecrow" for the United Kingdom. In fact, the apparatus of the Bretton Woods arrangements that Keynes subsequently helped to craft were designed to ease a difficult transition out of debt.

The case for near-term fiscal stimulus, even if in the form of increased infrastructure outlays, cannot ignore the medium-term outlook for economies with already large debt obligations, major entitlement burdens, aging populations, and what appears to be a steady downward drift in potential output growth.

As Skidelsky notes, debts have risen significantly in the UK and the US (among others) since 2008, while interest rates have remained low or declined. Should we therefore conclude that high debt is not linked to low growth via high interest rates (which crowd out private spending)?

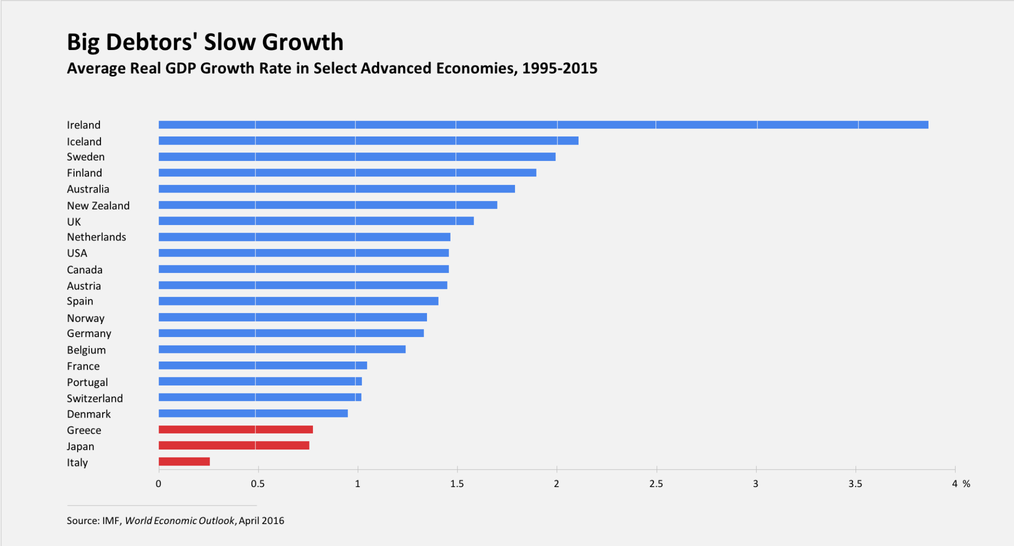
Reading a little further into my study with Rogoff and Reinhart, one would find that there was ''little to suggest a systematic mapping between the largest increases in average interest rates and the largest (negative) differences in growth during the individual debt overhang episodes."

Our research considered 26 high-debt episodes between 1800 and 2011, looking both at growth rates and at levels of real (inflation-adjusted) interest rates. In 23 of these high-debt episodes, growth was lower, and in eight growth slowed even as real interest rates remained about the same or edged lower. Japan's debt overhang (entirely domestic currency debt), which we trace back to 1995, illustrates this pattern.

Why do high debt and slow growth coexist, despite cheap financing?

High debt levels can and do constrain a country's abilities to cope with adverse events. For example, some of Italy's largest banks have been diagnosed as approaching insolvency and requiring substantial recapitalization. Not surprisingly, the confidence of Italian households and firms has been shaken, and capital flight has ensued. If Italy's debt were not already 130% of GDP, might its government have been better positioned to provide the resources to tackle decisively its lingering banking and confidence problems?

Our 2012 study identified three ongoing public-debt overhangs that began in the mid-1990s – Greece, Italy, and Japan. Relative to other advanced economies, these three economies are the worst growth performers (see chart). To be sure, a country's economic performance depends on many factors. But the view that it is low growth that causes debt to rise, though important when assessing the cyclical feedback effects, can hardly explain the two-decade experience of these three countries.




It is difficult to imagine a sustained revival of Greek growth without another round of haircuts and debt forgiveness from Greece's official creditors, which now hold most of its debt. Italy depends critically on the continued large-scale purchases of its bonds by the European Central Bank (its Target 2 balances have recently climbed, reflecting capital flight). The Bank of Japan is going to greater and greater lengths to orchestrate an increase in inflation expectations and price growth, which can help erode the value of outstanding debts. ("For inflation is a mighty tax-gatherer," as Keynes observed.) Other countries, like Portugal, are also struggling with low growth and weak fiscal positions.

Concerns about debt levels (public and private) have now extended beyond the advanced economies to many emerging markets. I cannot recall an instance of a government that is concerned about having too low a level of debt. Perhaps, it is because the debt scarecrow has teeth.

Skidelsky needs no reminder of the historical record, but it bears noting that more than a dozen advanced economies received debt relief in one form or another during the depression of the 1930s. The approach to unwinding current debts is likely to vary considerably across countries, but it is time to place greater emphasis on debt restructuring (which comes with a menu of options) than on accumulating more debt.