The Collected Works of
James M. Buchanan

VOLUME 2

Public Principles of Public Debt

James M. Buchanan

The Collected Works of

James M. Buchanan

VOLUME 2

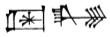
Public Principles of Public Debt

A Defense and Restatement

LIBERTY FUND

Indianapolis

This book is published by Liberty Fund, Inc., a foundation
established to encourage study of the ideal of a society of free
and responsible individuals.



The cuneiform inscription that serves as our logo and as the design
motif for our endpapers is the earliest-known written appearance
of the word "freedom" (*amagi*), or "liberty." It is taken from a clay
document written about 2300 B.C. in the Sumerian city-state of Lagash.

Printed in the United States of America

First published in 1958 by Richard D. Irwin, Inc.

01 15 16 17 18 C 6 5 4 3 2
15 16 17 18 19 P 6 5 4 3 2

Library of Congress Cataloging-in-Publication Data
Buchanan, James M.
Public principles of public debt.
p. cm. — (The collected works of James M. Buchanan ; v. 2)
Includes bibliographical references and index.
ISBN 978-0-86597-215-5 (alk. paper). —ISBN 978-0-86597-216-2 (pbk. : alk. paper)
1. Debts, Public. I. Title. II. Series: Buchanan, James M.
Works. 1999 ; v. 2.
HJ8015.B8 1999
336.3′4—dc21 98-45533

LIBERTY FUND, INC.
8335 Allison Pointe Trail, Suite 300
Indianapolis, IN 46250-1684

"I find little use for the hypothesis that error becomes truth merely by long or consistent practice."

—Henry Simons, "On Debt Policy"

"I must confess, that there is a strange supineness, from long custom, creeped into all ranks of men, with regard to public debts, not unlike what divines so vehemently complain of with regard to their religious doctrines."

—David Hume, "Of Public Credit"

Contents

Foreword

Begin with a picture. Here is the young Jim Buchanan, strolling down the stairs of the Hotel d'Inghilterra in Rome after breakfast in early 1957. He is preoccupied. His brow is slightly furrowed. Suddenly, he looks up, and his head tilts back. A slightly incredulous look comes over his face. Apparently, something puzzling had in an instant become clear. He races down the remaining steps and hurries over to a small writing room that graces the foyer of the hotel. Grabbing some pieces of hotel stationery, he proceeds feverishly to jot down the crucial points. *Public Principles of Public Debt*[1] is born.

It is, for Buchanan, the only book that will come about in this way—as a flash of inspiration. Other works may be no less inspired in an intellectual sense—and no less inspiring to readers. But *Public Principles of Public Debt* is the only work that will begin with an experience of quite this Road-to-Damascus quality. And the feverishness does not end here. The central point of the argument, once seen, is so obvious to Buchanan—the prevailing orthodoxy on public debt incidence (which he had previously thoroughly imbibed) so clearly wrong—that he cannot wait to get the book written and into print. As he presses forward with the writing, he anxiously examines the journals, fearful that with so obvious a point he might well be scooped. The natural impulse of intellectual excitement works together here with considerations of professional prudence to drive him on.

Was he right to be anxious? To judge by the book's puzzled reception and the confused literature about it that emerged over the ensuing decade, probably not. What was obvious to Buchanan was clearly not so obvious to everyone else. Indeed, there remained a constituency, particularly within mac-

1. James M. Buchanan, *Public Principles of Public Debt: A Defense and Restatement* (Homewood, Ill.: Richard D. Irwin, 1958), volume 2 in the series.

roeconomics, that was staunchly resistant to and suspicious of the Buchanan insights. Nonetheless, Buchanan was right to feel that much was at stake, both professionally and academically; *Public Principles of Public Debt* was, after all, Buchanan's first monograph. And in this sense, it added a depth and substance to his vita to set alongside the impressive array of important journal articles he had already produced. Moreover, the line of argument had important influences on his subsequent work. For example, the subjective cost theme in *Cost and Choice*[2] owes much to the reflections about cost that are developed in *Public Principles of Public Debt,* and the important public choice implications of the *Public Principles of Public Debt* argument surface explicitly in *Democracy in Deficit.*[3]

To elaborate, part of the concern of the "new orthodoxy" in claiming that the burden of debt (at least, internal debt) is borne currently, in the period that the expenditure is undertaken and precisely *not* passed forward to future generations as (allegedly mistaken) popular view might have it, was to offset ethical inhibitions about deficit financing. If Buchanan's claim was right, and the burden of debt financing was indeed borne by "future generations," then debt financing might well encourage both excessive reliance on debt and excessive levels of spending. To the extent that the future generations in question were indeed different persons, not alive (or not enfranchised) at the time the expenditure operation was undertaken, then the fiscal operation would not (and by definition *could* not) fulfill the Wicksellian contractarian requirement that virtually all affected parties should be free to reject the expenditure. In the absence of a restriction on debt financing, ordinary democratic processes could not prevent the current generation of voters-taxpayers from passing forward the cost of as much current expenditure as they were inclined to and—if the cost was to be borne by others—voting for themselves projects whose total benefits, though positive, did not exceed total costs. These aspects remain entirely in the background in *Public Principles of Public Debt.* The object in this first book by Buchanan is to establish a set of analytic claims about debt incidence. But the public choice aspects do pro-

2. James M. Buchanan, *Cost and Choice: An Inquiry in Economic Theory* (Chicago: Markham Publishing Co., 1969), volume 6 in the series.

3. James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (New York: Academic Press, 1977), volume 8 in the series.

vide some of the (possibly unconscious) subtext in *Public Principles of Public Debt* that Buchanan and Wagner, in *Democracy in Deficit* and elsewhere, make explicit and develop in a more complete way.

These public choice anxieties are, of course, very much in play in the more recent debate over implicit social security debt. This latter debate has, in fact, proceeded somewhat independently of the Buchanan book and has focused on slightly different aspects of the whole issue. In particular, it has been mainly concerned with the question of the effects of debt financing on the capital stock. The classic papers here revolve around the rival claims of Martin S. Feldstein and Robert J. Barro—the former claiming to establish econometrically the empirical magnitude of the effects of social security arrangements on the United States capital stock, the latter purporting to show (through a reinvention of the so-called Ricardian equivalence theorem) that, for fully rational individuals, public debt will have virtually the same effect as taxation.[4] It is an interesting twist here that Barro's agenda is in part an anti-Keynesian one. In 1958, the Keynesian position was that (internal) debt and tax financing were more or less equivalent—at least in the intertemporal allocation of burdens. By 1974, however, the Keynesian position seemed entirely reversed. It was, by 1974, recognized that if taxes and debt were essentially equivalent, then standard macroeconomic policy measures based on deficit management could have no effect on the economy—macroeconomic or otherwise. In fact, the Barro-Feldstein debate—or the debate that might have been—got somewhat sidetracked because of problems with the replicability of Feldstein's data. However, it should be clear that neither Barro's conclusions nor his approach would be particularly congenial to Buchanan. It is essential to Buchanan's argument that debt financing has an effect: the difference between Buchanan and the Keynesians was rather whether such effects were desirable or not. More to the point, perhaps, Barro's central question (and the title of his influential paper)—"are government bonds net wealth?"—is set at a more aggregative level than Buchanan's analysis in *Public Principles of Public Debt.* Indeed, in an important sense, the basic contri-

4. Martin S. Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Accumulation," *Journal of Political Economy* 5 (September–October 1974): 905–26; Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy* 6 (November–December 1974): 1095–117.

bution in *Public Principles of Public Debt* is Buchanan's insistence on an appropriately disaggregated, individuated mode of analysis. To the standard new orthodox claim that we owe internal debt to ourselves, Buchanan's response is effectively: What's this "we" business? Once it is recognized that incidence analysis depends on isolating which individuals in which capacities face a liability as a result of a fiscal operation, claims about the community as a whole are seen to be essentially irrelevant and potentially misleading.

It is, of course, not necessary here to repeat Buchanan's argument. That is elegantly and clearly set out in the ensuing text. But, it is worth noting that there is a kind of intellectual divide between those who conceive social phenomena in a disaggregated way and those of a more holistic, organic cast of mind. Arguably, it is this intellectual divide that most distinguishes micro- from macroeconomists and *a fortiori* economists as a group from sociologists and many traditional political theorists. Within this divide, in *Public Principles of Public Debt,* Buchanan establishes himself firmly as an arch exponent of the individualist method.

The years immediately following the publication of Buchanan's book gave rise to an extensive literature, the most important elements of which are reproduced in James M. Ferguson's book, *Public Debt and Future Generations.*[5] Unsurprisingly, public debt has been a recurrent theme in Buchanan's writings over his entire career. And in the more recent resurgence of interest in the topic surrounding the analysis of social security policy, Buchanan has had occasion to revisit earlier themes. What is perhaps surprising, given the change in intellectual climate since the heyday of the new orthodoxy and the overwhelming predominance of Keynesian thinking throughout the fifties and sixties, is how fresh and relevant *Public Principles of Public Debt* remains. To be sure, some minor pieces of the book (most notably the appendix) are somewhat dated and have been included in the present version largely for

5. James M. Ferguson, ed., *Public Debt and Future Generations* (Chapel Hill: University of North Carolina Press, 1964). The Buchanan contribution written specifically for the Ferguson collection, "Public Debt, Cost Theory, and the Fiscal Illusion," 150–63, is reproduced in the Collected Works in volume 1, *The Logical Foundations of Constitutional Liberty.* Another Buchanan paper reprinted in the Ferguson volume, " 'La Scienza delle finanze': The Italian Tradition in Fiscal Theory," in *Fiscal Theory and Political Economy: Selected Essays* (Chapel Hill: University of North Carolina Press, 1960), 47–54, is reproduced in the series in volume 15, *Externalities and Public Expenditure Theory,* along with Buchanan's other articles on public debt.

reasons of completeness. But these aspects are minor and do not detract (or *dis*tract) from the power and sweep of the central argument. In fact, *Public Principles of Public Debt* remains one of Buchanan's most important and influential books. The force of this observation is hardly diminished by the observation that some of this influence is revealed in Buchanan's own subsequent writings.

Geoffrey Brennan
Australian National University
1998

Preface

Under what conditions is a book conceived? If we knew, I suspect that we could predict with reasonable accuracy the characteristics of the progeny. The pedestrian parade of factual detail which often epitomizes the published doctoral dissertation reflects the forced mating of reluctant author and uninspiring material. The smashing of straw men suggests the rapacious advance of a zealous author determined to defeat his opposition rather than to provide enlightenment.

Because it seems likely that I shall be placed in the second of these categories by some of my professional colleagues, let me explain in some detail just how this little book has come to be written. First of all, I should state that for many years I have accepted what I have called in this book the "new orthodoxy" of the public debt. In my study I have absorbed this doctrine uncritically; in my teaching, I have encouraged others to do the same. If there is no evidence of the "new orthodoxy" in my published papers, this reflects a full and unquestioning integration of the doctrine in my own thinking rather than the reverse.

One great value of considering practical questions of public policy or "political economy" is that the economist is forced to question the validity of so many of the basic elements in his conceptual scheme of things. My reexamination of public debt theory stems directly from my work on a currently important issue in political economy, the national highway problem. In the academic year, 1954–1955, I started working on a manuscript, which remains incomplete, of a book on economic policy in this area of emerging national importance. In the first draft I reached a point at which an appropriate chapter on "Taxes versus Loans" should have appeared. At about this same time, in the spring of 1955, I was serving as a consultant for the Committee for Economic Development. The Committee was attempting to for-

mulate a policy statement on highway modernization, and especially on the methods of financing highway improvement. (The Committee's views are published in the policy statement, *Modernizing the Nation's Highways,* issued in January, 1956.) Central to the highway problem was, and is, the issue of pay-as-we-go versus go-as-we-pay. The Presidential Advisory Committee, under the chairmanship of General Lucius Clay, had proposed a vast new issue of special bonds to finance an accelerated development of an interstate highway network. This financing scheme was given the now-famous lukewarm treatment by the then Secretary of the Treasury Humphrey, and the proposal aroused bitter congressional and public opposition. What was the desirable means of financing highway improvement, admitted to be needed by almost all parties to the discussion? Should taxes be increased sufficiently to cover the full current outlay from currently collected funds, or should public borrowing be accepted as an appropriate means of financing? Surely here was a problem upon which professionally trained economists should be able to shed some light.

Two things became clear very quickly. First, economists seemed to be able to contribute surprisingly little to the solution of this problem, and, secondly, what little they could contribute was based on a "dusting off" and a utilization of "public" or "classical" views on public debt theory and policy. The conception of the public debt which has achieved dominance among economists during the last twenty years and which characterizes economic thought today was useless in the full-employment world of the 1950's. The chapter on "Taxes versus Loans" remained unwritten. The Highway Revenue Act of 1956 was passed, which incorporated the pay-as-we-go principle of financing, largely reflecting the "vulgar" or "man-on-the-street" opinions about public debt creation.

During the academic year 1955–1956, I was awarded a Fulbright Research Scholarship for study in Italy. In the course of this work I found that the Italian fiscal theorists have devoted a great deal of attention to the Ricardian proposition that taxes and loans exert identical effects upon an economy. This proposition was debated fully in the works of the classical Italian scholars in public finance: Pantaleoni, De Viti De Marco, Griziotti, and Einaudi. In a year largely devoted to reading widely in a foreign language it is extremely difficult to isolate those particular works which specifically affect and

modify one's thinking. But I now believe that an approach to public debt theory employed by Pantaleoni, despite the fact that his conclusions were erroneous, led me first to question a single bulwark of the "new orthodoxy," namely the sharp conceptual distinction which it makes between the internal and the external debt. This initial questioning was further motivated by a later reading of some of Einaudi's works. In a specific sense none of the Italian theorists appears to have formulated a fully acceptable theory of public debt and, indeed, the dominant theory in Italy, even prior to the 1930's, has much in common with that which characterizes the "new economics." But the Italian approach to the whole problem of public debt was instrumental in shaping my views as they now stand, and I should, therefore, acknowledge this influence.

Stimulated indirectly by the work of Pantaleoni, I prepared a note on the distinction between the internal and the external public debt in which I tried to show that the currently accepted views must be modified. A version of this note appeared in the *American Economic Review* for December, 1957. A somewhat different version appears as Chapter 6 of this book, and I gratefully acknowledge permission of the editors in allowing me to reprint those portions of the argument which are identical. So firmly anchored in my own thinking were the other two bulwarks of the new orthodoxy that, even in writing the early versions of this critical note, I accepted these two without question. The note was completed in early 1957, after which I returned to the highway manuscript with a view toward finally writing the chapter on "Taxes versus Loans." It was only in the process of writing this chapter that I came to the full realization that the two remaining bulwarks of the "new orthodoxy" are also untenable. I came to realize that the analogy between the public economy and the private economy is applicable to most of the problems of the public debt and that public debt creation does involve a shifting of the real burden to future generations of taxpayers.

Somewhat to my surprise, therefore, I now find myself in the camp of the much-maligned man on the street, the holder of the allegedly vulgar and unsophisticated ideas about the public finances. This heresy places upon me a somewhat greater obligation to spell out the ideas involved in my proposed overthrow of the ruling orthodoxy carefully and precisely. In the chapters which follow I shall not be tilting at windmills nor shall I be attacking straw

men. I hope that economists will accept my discussion of the ruling theory of public debt as a fair one. I shall try to show the weaknesses in the orthodox approach and to suggest an alternative one.

The discussion will contain little that is completely new or different. Many parts of it will be readily accepted by those who have been instrumental in shaping the "new orthodoxy" in its current form. Some elements of the argument are to be found in the qualifications which the more careful expositors have used to frame their analyses. And almost all of the ideas developed in this book may be found in "classical" public debt theory. The book will essentially re-establish this theory as the general one. Traces of this "correct" theory are to be found alongside traces of the opposing views throughout the history of the subject.

It is understandable that the now-prevalent theory only gained and held its position of dominance in the decade of the 1930's and its aftermath, the 1940's, although the theory had, of course, been advanced frequently during earlier periods. The approach was directly tied to, and indeed could scarcely have been divorced from, the "new economics." But just as other elements of the "new economics" have been found wanting in the 1950's, so with the public debt theory which it espouses. The time for a shift in emphasis, a synthesis, has arrived.

The book will be limited to a discussion of principles. There would be little usefulness in parading factual details which are either familiar or readily available to the reader, the recounting of which would represent a chore for the writer and a cost to the publisher. I shall first describe the new orthodoxy. Following a brief methodological chapter, I shall then examine each of the three basic propositions of the new orthodoxy. I shall then review the pre-Keynesian literature. This will be followed by an extension of the analysis to the nonclassical cases of depression, war, and inflation. Only in the latter part of the book will I face the issue of "taxes versus loans," and, finally, I shall examine the question of debt retirement. Following the main text there is an Appendix which suggests a conceptual revaluation of the national debt. This Appendix represents an application of the theory developed in the book to the measurement problem. The analysis of the Appendix should be considered exploratory rather than definitive, and the nonspecialist reader may omit the entire Appendix without damage to his understanding of the essential argument of the book.

Colleagues have been helpful in two ways. First, they have made valuable critical comments on earlier drafts of the manuscript, comments which have caused me to remove errors, to modify style, and to shift emphasis. But perhaps more importantly, they have encouraged me to proceed with the publishing of this little book, to believe that its belaboring of a few basic notions may serve some useful purpose. Among these colleagues I should especially mention: Marshall R. Colberg, G. Warren Nutter, James R. Schlesinger, Tipton R. Snaveley, and Leland B. Yeager.

The Institute for Research in the Social Sciences of the University of Virginia provided me with financial aid during the summer of 1957 when the basic writing of the book was completed. In the final putting of black on white, I am indebted to Mrs. Gladys Batson, who typed the manuscript, and to my wife, who has provided editorial assistance. For Mrs. Batson's services, I am indebted to the recently established Thomas Jefferson Center for Studies in Political Economy of the University of Virginia.

James M. Buchanan
Charlottesville, Virginia
December, 1957

Public Principles of Public Debt

1. The Economists and Vulgar Opinion

"Many a citizen will never be able to understand fully the problem of the public debt, for it is too complicated for the average layman. On these technical matters he will have to accept the word of the experts."[1] This statement by Professor Seymour Harris has two noteworthy implications. It is, first of all, a rather severe indictment of the ability of economists to fulfill their educational task. Secondly, it suggests that the experts themselves are agreed on the "truth."

On the face of it, the problem of public debt does not seem complicated. Indeed it seems quite simple when compared with the problem of the circular flow of goods and services in a money economy. Yet it is in regard to the latter problem that great insight has been imputed to businessmen and lay leaders in times past. Critical historians of economic thought may legitimately question the depth of genuine understanding about the unemployment problem contained in the Mercantilists' or Protectionists' "fear of goods" or even in the Reverend Malthus' predictions of a general glut. But economists, especially during the last quarter century, appear to accept almost universally that common everyday opinion on the public debt is fundamentally wrong. Any challenge to this relative unanimity stands in danger of being rejected at the outset. Surely, we are inclined to say, the vulgar ideas about the public debt are grounded in almost pure fallacy, fallacy which is so simple and obvious that we expose it in the early chapters of our elementary textbooks. We use the common lay reasoning on public debt as a particularly good example of the fallacy of composition before we lead the sophomore

1. Seymour E. Harris, *The National Debt and the New Economics* (New York, 1947), p. 25. Cited by permission, McGraw-Hill Book Company.