The true costs of national debt

Pierre Lemieux’s new book casts much-needed light on an issue that will hound generations to come, according to Julie Novak
Among the estimated 3.5 billion websites around the world, there is one that is almost guaranteed to keep adults lying awake at night and force horrified children to run for cover. It is the global public sector debt clock website maintained by the Economist Intelligence Unit. At the time of writing, total public sector debt owed by governments across the globe amounted to over $50 trillion, and the debt shows little sign of arresting its growth momentum. Until the recent past, the average person would have been forgiven for thinking that unsustained public indebtedness was only reserved for tin pot African or Latin American dictatorships, whose leaders aspired to live high on the hog through a process of sending their countries into hock.

While rising public sector debt has been admittedly something of a simmering issue for the United States and Europe since the 1970s, the return of the economics of John Maynard Keynes and Abba Lerner during the 2008-09 ‘global financial crisis’ signalled an extraordinary act of synchronised borrowing gluttony by all Western countries. Even if the near wall to wall state Labor governments during the Howard era were unwinding the borrowing parsimony of their predecessors, the fact of the matter is that Australian governments, especially at the federal level, unashamedly signed up to the new global debt club once the GFC horse got galloping.

According to a historical public debt database maintained by the IMF, the gross debt of the Australian government sector, expressed as a percentage of GDP, rose from 11.8 per cent in 2008 to 16.9 per cent in 2009. In other words, the gross debt to GDP ratio increased by 43 per cent during a period in which former Treasury Secretary Ken Henry exhorted the Commonwealth government to respond to the GFC by ‘going early and going hard.’ Gross debts incurred by Australian general governments have continued to grow since that period, rising to 24.2 per cent of GDP in 2011. In internationally comparative terms, Australia has been one of the debt growth frontrunners with general government gross debt to GDP increasing by 106 per cent from 2008 to 2011, only behind Ireland (140 per cent) and Slovenia (113 per cent) in the OECD.

These figures necessarily understate the debt burden, however, since governments own and operate public utilities which are covered by at least implicit guarantees of debt funding. After incorporating these utilities, the non-financial public sector gross debt to GDP ratio for Australia jumps to 15.1 per cent of GDP in 2008 rising to 28.6 per cent in 2011. With proposals for governments across Australia to borrow more heavily, for example on a raft of infrastructure projects with questionable economic returns, taxpayers have been confronted with some basic questions that require answers grounded in sound economic theory. Is public debt a problem? What are the consequences of increasing public debt? Should rising debt prove to be economically harmful, what should be done to reduce debt?

A recent book written by French Canadian economist Pierre Lemieux, *The Public Debt Problem: A Comprehensive Guide*, serves as a most timely accompaniment for any taxpayer seeking to arrive at the answers to these pressing questions. Firmly grounded in the public choice theoretical approach, *The Public Debt Problem* depicts the ruling political class as an emperor who overspends and borrows, but who nonetheless does not realise that his inclination to raise debts with near impunity will eventually render him economically exposed. It is well known in the economics literature that increasing public sector debt will eventually crowd out private sector investments, in turn acting as a drag upon economic growth, whereas taxes raised to repay debts distort economic activities and hamper market processes. Lemieux depicts a perpetuating cycle, which seems particularly evident in Europe, whereby public debt that reaches a critical mass compromises economic growth outcomes, reducing the capacity of government to raise revenues and service its debts, and even more debt burdens reduce growth, and so on.
The book draws upon empirical research to support that point, for example quoting a notable recent empirical study suggesting that a ratio of gross debt to GDP exceeding 90 per cent leads, on average, to a cumulative 24 per cent loss in gross output. One of the more important discussions in *The Public Debt Problem* concerns the complex web of financial relationships between indebted governments and financial intermediaries, such as large banks, many of whom benefited from a range of bailouts during the GFC. Financial sector regulations have contributed to a process in which governments ensnare private financial institutions within their gravitational pull, thus allowing governments to more easily borrow, for example, by putting obligations on banks to purchase their securities on favourable terms. The GFC era practice of central banks radically lowering their interest rates has also been used to assist governments to alleviate the interest costs of debt, even if the rock bottom interest rate strategy implies the destruction of productive capital in the longer term. Finally, Lemieux carefully weighs various options all of which have been openly canvassed in public policy discourse about what the US should do to resolve its debt problem. Should the government announce an open default on its debt obligations? Should it undertake a stealth default through inflation? Should government expenditure be reduced? Should nothing be done whatsoever? Doing nothing is ruled out in *The Public Debt Problem* as a sustainable course of policy action in an era of high debt, as it would perpetuate the current run of economic underperformance and may, in any case, amount to an eventual disorganised default fraught with numerous economic risks. The stealth default option of repaying the debt through money printing, otherwise known in the common parlance as ‘quantitative easing,’ is dismissed as a feasible option, in that the eventual costs of price inflation would create serious distortions in real markets. A default through the backdoor of inflation would likely raise the prospect of other policies, such as tariffs and capital controls, exhausting opportunities for economic exchange, and could even have disastrous political consequences should voters crave for a ‘strong leader’ to resolve the problems caused by government policy in the first instance.

Lemieux maintains a fairly sanguine view about the merits of an open default of existing debts, labelling it the least bad alternative ‘if feasible and if spending cannot be deliberately reduced.’ However *The Public Debt Problem* canvasses a number of important caveats militating against the feasibility of such an option, including potential resistance by powerful creditors, a loss of reputation in capital markets, potentially reduced access to financial markets for repudiating governments, and lost opportunities to institutionally restrain large public sectors.

Ultimately, Lemieux’s first preference, is for a significant reduction in government spending, particularly focussed on the rationalising the welfare state
and reducing government roles in productive functions that can be readily undertaken by the private sector.

As desirable as it would be to starve the fiscal leviathan and force politicians to reconfigure their spending priorities, Lemieux is under no illusion this is a seemingly monumental task: ‘government missions have been creeping up, and sometimes exploding, for more than a century. Give Leviathan an inch, and he will take a mile.’ However the realisation of systemic reductions in government expenditure, according to Lemieux, would yield the significant upside of a restoration of liberty and prosperity enjoyed by previous generations. As he describes it, ‘it is in the whole Western world that the sovereign debt crisis provides an opportunity to chain Leviathan.’

Although The Public Debt Problem is primarily written for an American audience it contains more than sufficient conceptual material that can be universally applied to explain the debt problem, and the mechanics of public borrowing described in the book are similarly applied by most Western governments including those in Australia. As a more practical matter, the spiralling debts confronting the United States and Europe continue to weigh down those respective economies, with significant flow on implications for economic performances of Australia and other Western economies. In other words, it is essential that Australians understand the problems of the US and Europe to appreciate why the world seems stuck along a slower lane of growth post GFC, and why we should at every turn refuse to travel down the failed Northern Hemisphere path to fiscal penury.

Written in a style comprehensible to the intelligent layperson, Pierre Lemieux’s The Public Debt Problem: A Comprehensive Guide injects welcome clarity and insight into an issue that has long been held hostage by the empty rhetoric and false analysis of proponents for larger government.

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| 2011 | That debt has since risen to 24.2 per cent of GDP in 2011 |
| 2008-2011 | Australia’s general government gross debt to GDP has grown by 106 per cent from 2008 to 2011, third highest in the OECD |

The non-financial public sector gross debt to GDP ratio for Australia has increased from 15.1 per cent to 28.6 per cent from 2008-2011.