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Theory of Public Debt and Current Reflections

Sibel Aybarç

*“The public debt is a burden on the back of our children and grandchildren...
All debt is evil; public debt absolutely evil [1].”*

Abstract

From the ancient ages to today, administrations needed continuous financing and met this financing with various sources. The process of social development necessitated public borrowing for different purposes ranging from *creation of a consumer society to sell the surplus of developed countries to postwar human relations* and from the *development financing of developing countries to the payment of debt by debt*. Particularly after World War II (1941–1945), the developed countries provided the external resources to developing countries for development financing. As a result of the increase in the mobility of capital in the process of globalization (especially short-term speculative capital investments), developing countries were dragged to the debt-interest helix problem and the external debt crises. The stabilization programs proposed by the IMF led to government guarantee of private sector external debts in the developing countries and led to a rapid increase in the public debt stock.

Keywords: public debt, internal debt, external debt, crowding out, globalization

1. Definition of public debts

In the modern state perspective, the needs constantly increase; therefore, the state has to spend more to meet these needs. Public expenditures are generally met by ordinary public revenues such as taxes, duties, fees, parafiscal revenues, property and enterprise revenues, taxes, and penalties. However, the state is faced with the public sector deficit due to reasons such as large infrastructure investments, war, development financing, natural disasters, economic crises, budget deficits, as well as the ever-increasing ordinary public expenditures. To overcome this situation, they refer to borrowing.

Borrowing is the taking of money and similar values for repayment after a certain period of time. Public borrowing refers to the legal obligation of the state to pay back the principal and interest to the holders of the predetermined rights in accordance with a certain schedule. Public credit and public borrowing referred as state borrowing in the economic literature mean debts taken by government or other public institutions [2].

Governments in ancient and medieval ages required funding, as in modern states. But governments did not borrow “publically” in the concept of drawing funds from a large populace and paying principal and interest, as like deferred taxes [3].

In the thirteenth century, public borrowing, including even the king's borrowing, was first scientifically examined by Charles Davemont in 1710. Thereafter, economists such as David Hume, Adam Smith, D. Ricardo, Malthus, J.S. Mill, J.B. Say, A.P. Lerner, and A.G. Hart have worked on borrowing. Smith and Ricardo opposed public borrowing. In their view, borrowing can be spent irresponsibly because of being an easy income; so that causes deterioration in the functioning of economic life. In this context, the classics have advocated that capital is wasted, and the debt burden is transferred to the next generations due to the inefficiency of public expenditures [4]. In addition, classics have defended that borrowing could be in some case such as large infrastructure investment and war but emphasized that it should be limited and not be kept on.

The public borrowing policies over the world have especially experienced a turning point with the World War I (1914–1918) and the Great Depression (1930s). During the period in question, John Maynard Keynes had proposed public borrowing as a war financing to England and argued that it would be useful. In the process that started with this proposal, public borrowing became an indispensable source of financing for the states. This situation does not mean that states participated in Keynesian theory. While public borrowing becomes an indispensable source of financing, it also brings the debt-interest cycle, poverty, and crises. The result of public borrowing leaves a great burden on the next generations. This situation has justified the classics [4].

Especially after the World War II, public borrowing indicated both significant increase and structural changes due to on the one hand the repair works of the countries affected by the war, on the other hand, the financing needs of developing countries [5]. In the following period, the borrowing process are no longer interstate and have started to gain a new dimension by establishing international organizations such as International Monetary Fund (IMF), World Bank (WB), International Finance Corporation (IFC), International Development Association (IDA), European Investment Bank (EIB), and Islamic Development Bank (IDB).

In the process of globalization, the mobility of capital has increased; and serious financial competition has emerged in global markets.

In particular, developing countries have sought to use them to development financing by attracting international short-term capital movements to their countries through various incentive instruments (such as low taxes, high interest rates, etc.). However, both the sudden fluctuation in capital movements and the implemented incentive mechanisms have dragged the developing countries to the external debt spiral.

2. Classification of public debts

Public debts are classified into various types according to their characteristics. When the public debt literature is analyzed, it is classified into three main groups according to maturity, resources, and voluntariness [6–9] (**Figure 1**):

- Public debts according to maturities: short-, medium-, and long-term public debts
 - *Short-term public debts (floating debts)* refer to debts up to 1 year. In short-term borrowing, treasury bills and treasury guaranteed bond are used.
 - *Medium-term public debts* refer to debts ranging from 1 to 5 years.
 - *Long-term public debts* refer to debts more than 5 years. The instrument of long-term borrowing is the government bond. These debts are provided from

the capital markets and have a higher interest rate than the interest rate of short-term borrowing. Long-term debts are classified as redeemable debts and irredeemable debts.

- Public debts according to sources: internal debts and external debts
 - *Internal borrowing* refers to a country's borrowing from own national resources. This borrowing has no effect on increasing or decreasing national income.
 - *External borrowing* refers to the resources provided from a foreign country that is repaid with principal and interest at the end of a certain period. External debt has an increasing effect on national income when it is taken and vice versa has a decreasing effect on national income when it is paid.
- Public debt as a voluntary basis: voluntary debts and obligatory debts
 - *Voluntary debts* refer the debts that are lent to the state by its own will and desire.
 - *Obligatory debts* refer to the debts which are lent by forcing to take the bonds issued by the government. These debts are applied in times of war, natural disaster, or economic crises. In itself, it is classified as the debts taken by full compulsion, the debts taken by the threat of forcing, the debts taken by creating the necessary savings, and the liabilities taken by the moral coercion.

Productive and unproductive debts are also available. If the debts are used in construction, such as railways, power stations, and irrigation projects, which contribute to the productive capacity of the economy, they denote to productive debts. By this way, productive debts provide a constant flow of income to the state. The state generally pays the interest and principal debt amount from these projects' revenues. If the debts are used in the area such as war, famine relief, social services, etc., which do not contribute to the productive capacity of economy, they denote to unproductive debts. The state generally pays the interest and principal debt amount from taxes; therefore, these debts are a burden on the society [10–12] (**Figure 1**).

Today, rapidly increasing international relations have increased the importance of external debts. The less developed and developing countries have to refer to external borrowing for the realization of their economic development. The lack of adequate capital markets for development in these countries and the insufficient number of technical materials and personnel required external resources. As a matter of fact, these are the main reasons for applying to external borrowing in the Ottoman Empire and the Turkish Republic periods before internal borrowing [13].

Internal and external borrowing amounts are adversely progressed in less developed and developed countries. According to this, the debts of developed countries are predominantly internal debts; the debts of less developed and developing countries are mostly external debts. Because in developed countries, the state can easily provide the debts needed by own internal sources. It is also important from where and how the sources of funding are provided in a country's economy as well as how these resources are channeled back into the economy [13].

As it is known, external borrowing has an increasing effect on national income when taken and has a decreasing effect on national income when paid. Because of these features, it is important to use for what purpose external borrowing. For instance, the *development credits*, that are provided in order to investing in economic development and increasing the existing investments, contribute to the economy by using the programs and projects included in the development plans. Development credits are dealt within four groups [6, 9, 13]:

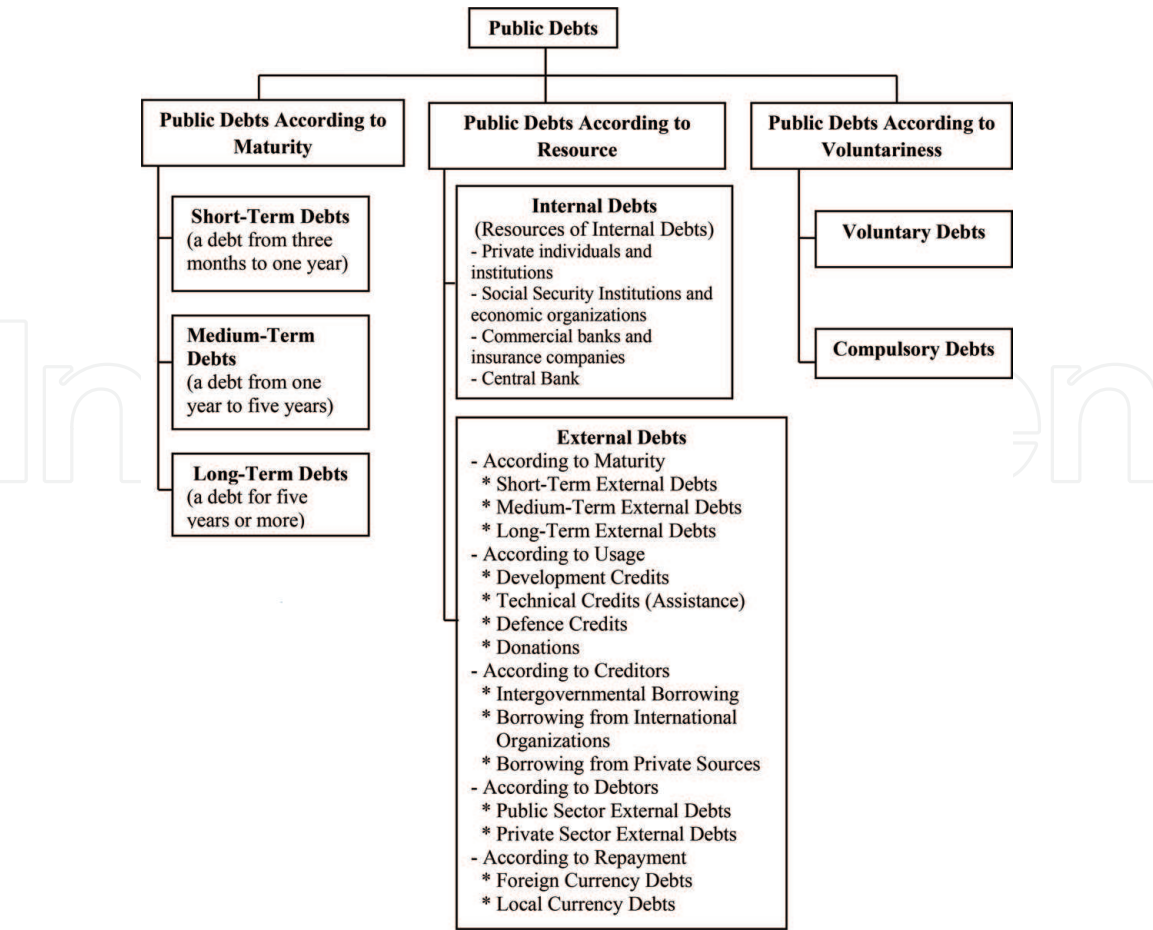


Figure 1.
Classification of public debts. Note: Prepared by the author by utilizing from literature.

- Project credits and program credits
 - *Project credits* are the credits that provided for the purpose of realizing the investment projects in the development plans of the countries. Countries that request credit provide projects with detailed information to countries or organizations that will give credit. Project credits are accredited/opened for the financing of eligible projects. Thus, less developed and developing countries are forced to use credits in a productive area, while creditor countries or organizations have the opportunity to control their credits. The biggest drawback of these credits is the long time for the preparation, submission, and creditor approval of the project, which makes the efficient use of credits more difficult.
 - *Program credits* are the credits that received for the purpose of importation of raw materials, semifinished goods, finished goods, and spare parts required for development targets in general. It is more flexible to use because it is not connected to any project. Thus, with the help of program credits, import bottlenecks are eliminated and the economy is kept in working condition. Therefore, it is a credit that is demanded more by developing countries.
- Tied loans and soft loans
 - *Tied loans* refer to the credit that should be used in the country which gave the credit. In this case, the debtor country does not have the authority to spend the credit on its own request. Nowadays this feature of loans granted

by developed countries generates to establish the system that is working in favor of the lender countries. Thus, the creditor country has provided advantages such as new foreign market, export growth, employment increase, and technology transfer. In terms of the debtor country, the situation is not bright at all. The borrower country is exposed to practices that increase the real cost of a loan such as buying a product from creditors at a much more expensive price than the normal market rate, transporting the goods through the creditor country's transport system and insuring them by the creditor country's insurance system. Hence, countries that receive loans remain under heavy debt burden.

- *Soft loans* are credits that granted the free use of developing countries. Thus, the debtor countries can provide the goods and services necessary for development financing from the international market in the cheapest way.
- Debt postponement and refinancing credits
 - *Debt postponement* is to postpone debt payment for an expired credit to a later date in return for a lower rate of interest compared to the first interest rate.
 - *Refinancing credits* are to pay an expired debt by the creditor country with the same amount of a new loan (a new debt). The main reason for creditor countries to accept debt postponement and refinancing credits is to enable them to accept some new commitments to the debtor country with these instruments. Thus, the creditor country can direct the debtor country's economic policies in line with its own advantages.

3. Effects of public debts

Borrowing has an important place among the public revenues, so its political, economic, and social impacts have great importance. The political effects of public borrowing are handled within the framework of political business cycle theory. According to theory, public expenditures increase during the election period. The government with the vote worry increases the public investments, but prefer to finance these public expenditures with internal borrowing instead of tax or emissions. In the short and medium term, governments, that do not want to seem repellent for voters, transfer the debt principal and interest payments to the next governments in the long term. This situation brings along the debt burden, which is often worsening with an alternative to closing debt with debt in developing countries [15].

Economic and social effects of borrowing take place in different ways in the following condition [4, 8]:

- To be long- or short-term maturity
- To spend or to keep the source that provided from borrowing
- To borrow from internal and external sources

The long-term or short-term maturity of public borrowing determines the duration of the contraction or expansionary effects. In this respect, the short-term borrowing changes the economic conjuncture frequently, because of the more liquidity and monetization feature of short-term debt instruments. If the resources obtained

by borrowing are expended, it causes an expansionary effect; if the resources obtained by borrowing are not expended, it causes a contractionary effect [4].

In order to provide the expected results of debt policies (i.e., borrowing methods, credit instruments, and payment and redemption methods), the economic effects of borrowing should be well known and analyzed. At this point, the source of the public debt and the place where it is used gain importance [2, 4, 5, 8, 14, 16]:

- The effect of public debt on the general level of prices: It is true that borrowing will create a deflationary effect only when it is considered as a bond sale. Because the private sector uses its own resources for buying public bonds, therefore, the private demand and the total demand are decreasing. This situation causes deflation by reducing the general level of prices. However, the state purchases goods and services with the resources that are collected from the sale of bonds or bills; thus the total demand increases due to public demand. This situation causes inflation by increasing the general level of prices as a result of the operation of various mechanisms.
- The effect of public debt on income distribution: The effect of public debt on income distribution depends on which income groups burden with debt costs and depends on which income groups are the obtained debt sources transferred to. This effect usually occurs during the principal and interest repayments. In particular in the internal borrowing, if the taxpayers and the lenders to the government are the same person or organization, there will be no inequality in the income distribution. However, vice versa, if the principal and interest payments related to public debt are paid by taxes collected from the middle- to low-income groups, then there is a transfer of resources from the middle- and low-income groups to the high-income group. This situation causes income distribution, the detriment of the middle- and low-income group, to deteriorate. In terms of external borrowing, the income distribution to favor of those beneficiaries from public expenditures in the period which they were taken was effected by the external debts positively. On the other hand, the external borrowing will affect the income distribution for next generation due to the debt burden adversely (such as the reduction of public expenditures and excessive tax payment). The effect of public debts on income distribution also points to the social impact of public borrowing.
- The effect of public debts on savings volume and investments: As long as the government canalizes to investing the savings that are collected by the way of internal borrowing, national income will increase, and personal income and personal savings tendency will increase. If the government transfers to budget deficit or consumption of the resources which recollected by internal borrowing, it will reduce the private sector investment amount by affecting the private sector's total savings volume. This event is called crowding out. The slowdown of national income growth as a result of the decrease in investments shows the real burden of the financing with borrowing instead of tax on the next generation. When debt is used to finance public expenditure, its real cost to society is the sacrifice in private sector production [17].
- The effect of public debts on economic development: if the funds provided through borrowing for economic development can be canalized to infrastructure investments (such as dams, roads, ports, mining, agriculture), they increase the new investments through multiplier effect. As a result, national income and employment increase; and accordingly economic development is ensured. Nowadays, less developed and developing countries, which make the development effort, resort to external borrowing due to insufficient internal

financing sources. If the aforementioned countries do not use external financing sources in the required fields, this situation may turn into debt financing by debt. This situation also shows the importance of debt management.

4. Current reflections of public debts

The phenomenon of globalization, which extends to geographical discoveries by origin, has gained momentum with the process of commercial and financial liberalization in the last quarter of the twentieth century. In this process, the globalization of capital, in particular, has dragged the developing countries, which have entered into a growth effort based on foreign capital, to the competition of encouragement (with high real interest rates, low exchange rates, and low tax rates). Increasing tax competition among developing countries led to a decrease in tax rates. The inadequate tax revenues for the financing of the increased public expenditures in these countries brought the need for new borrowing for the agenda. The application of high real interest rates to pay new debt principal and interest led to a rapid rise in the borrowing costs of developing countries and consequently a vicious cycle of debt-interest. Thus, the external borrowing process that developing countries started to finance development has undergone structural change. In this process, the method of closing the old debt with new debt (Ponzi-type financing) was adopted [18] (**Figure 2**).

Developing countries, which cannot overcome the lack of resources, have faced severe crises due to their fragile market structures. While the crises experienced until the 1980s stemmed from the balance of payment problems, in the globalization process, the nature of the crises has changed and has become the external debt crises and financial market crises (1982 Mexico, 1992–1993 ERM, 1994 Mexico, 1997 Asia, 1998 Russia, 1999 Brazil, 2000–2001 Turkey and Argentina) [19]. Thus, the volume of financial transactions in the global economy was only 15.3 times larger than the nominal GDP in the 1990s, while in the 2000s, it was 73.5 times larger. Equities, bonds, and foreign exchange spot transactions have nearly doubled the nominal GDP worldwide [20].

The world debt crises, which began with the declaration of the moratorium by Mexico in 1982 and spread by domino effect, caused the creditors to halt the supply of credit in a panic. Thus, developing countries, whose external debt burden has become more severe, had to implement the stabilization policies proposed by the IMF in order to get new loans or to delay debt. The process followed brought with

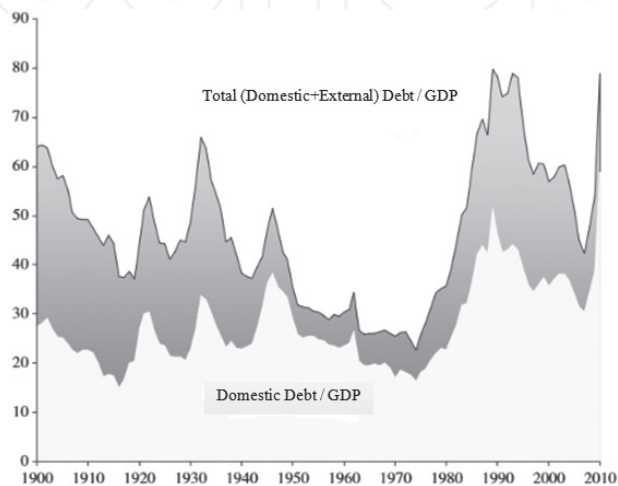


Figure 2.
Public debt (total and domestic debt) of all economies, as a percentage of GDP 1900–2010 [21].

inequalities in income distribution, unemployment, inflation, and poverty. On the other hand, developed countries have faced the problem of slowing capital accumulation due to the decrease in profit rates since the 1970s. This stagnation in developed countries has been tried to be overcome by lending excessive credit to developing countries through credit mechanism. Thus, both idle funds were evaluated in developed countries, and new markets were found for export increase [18].

For developed countries to sell the surplus production, firstly, it was necessary to create a consumer society. This is only possible by changing the basic habits of society. Intangible concepts such as cultural values, traditions, beliefs, etc. have gained importance as the basis for the use of the method of power based on economic power. Developed countries consciously use these power tools and encourage other countries to have their own culture and economic structure. In this way, it can be said that especially the developing countries are transformed into a consumer society, and thus they are continuously indebted for both public and private sectors [22].

In the globalization process, when the total external debt stock of developing countries is analyzed, it can be seen as a notable increase in short-term external debts and private sector external debts. Therefore, the process is called the rapid privatization of external debts. This phenomenon brings the important problems for developing countries. Short-term debts, which are not paid by the private sector (especially commercial banks) in times of crises, are taken under the state guarantee by IMF regulations. In the end, the short-term private sector debt was turned into long-term public debt by consolidating. After the 2001 crises in Turkey, we can see that the debt burden of bankrupt banks had transferred to the Treasury. As a result, Turkey's public debt has increased rapidly [18].

5. Conclusions

The state faced a financing deficit, when the ever-increasing needs in the social development process were not met by the state's ordinary public revenues (such as taxes, duties, fees, parafiscal revenues, property and enterprise revenues, taxes, and penalties). In addition to these expenditures, the state had to resort to borrowing due to major infrastructure investments, war, development financing, natural disasters, economic crisis, and budget deficits. From the borrowing of the king representing the country in the thirteenth century to the current debt crises, public borrowing has served different purposes in this process. This process has brought different debt types according to maturities (short, medium, long term), resources (internal and external debts), and voluntariness (voluntary and compulsory debts). Thus, borrowing overreached to be an extraordinary public revenue and has started to be perceived as a means of intervention to the economy. For example, the state uses internal debts as a tool to reduce demand in inflationary periods and to increase demand in deflationary periods.

In this section, which focuses on the political, economic, and social impacts and current reflections of borrowing in the context of public debt theory, the transformation in the external debt structure in the globalization process is emphasized. Initially external assistance and debts taken by developing countries as development financing have been used as a means to eliminate the stagnation by the developed countries in their economies. The given debts to the developing countries were used to increase the exports of developed countries, especially through tied loans. This situation has brought the new market, technology transfer, and economic power to the developed countries, while it has caused consumption society, external dependency, debt-interest spiral, and ultimately external debt crises in the developing countries. The restrictions of the structural adjustment programs have been

introduced by IMF to improve the fragile economies of developing countries against external debt crises. In this period, IMF has started to use this structural adjustment programs, which include strict structural reforms, by determining the economic and social policies of the debtor countries as a tool to serve the purpose of developed countries.

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