

## THE DEBT THREAT TO DEMOCRACY: PART II

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DeMuth has done us a great service by penning this essay on debt and democracy. Debt, in his view, has become “an important means of pleasing and placating voters while avoiding democratic accountability”. Since this cannot go on forever, the only way to preserve democracy is to find mechanisms to preclude politicians using debts in this way.

This is not, as he makes plain, an attack on the welfare state. There is nothing in this essay to preclude an electorate voting for a high-tax, high-spending Scandinavian welfare system. All DeMuth opposes is the “right” of the electorate to vote for a low-tax, high-spending outcome that loads the costs onto the next generation.

### **National Debt to National Income**

First off, let us be clear on the facts. Debt is problematic when you cannot service it. For that reason the convention that we express the national debt relative to national income is a sensible one. In those terms, the US national debt fell under Truman, Eisenhower, Kennedy, Johnson, Nixon, Ford, Carter and Clinton. It rose under Reagan, Bush I and Bush II, and Obama. Clinton—the most fiscally conservative President in modern times—proved that it was possible to win an election while materially cutting the debt, at least in the context of a strong global economy. But it is wrong to see democracy as leading to an arms race of unfunded pledges, whatever the performance of some recent Presidents.

DeMuth is right to chastise George W. Bush for his 2002 prescription drug programme, explicitly financed by deficit funding, and to take aim at middle-class welfare spending more generally. But he is not right to think that this is inevitable in a democracy. Rather, it is a peculiar feature of recent US politics.

Contrast the position with that of Britain. Our tax code has next to no deductibles. You cannot deduct mortgage interest. You cannot deduct work expenses unless you are self-employed. You cannot deduct student interest, or tuition fees or property taxes. There are limited deductions for pension contributions, and for cash donations to charity. But that is it. There isn't even a tax deduction for having children.

Britain has been cutting middle-class tax deductions and welfare spending for years, irrespective of which party has been in power. The Thatcher government limited mortgage deductions, for example, in 1988, and the Blair government abolished them altogether in 2000. The current government has announced new limits to deductions for charitable giving, as well as ending to universal child benefit, a \$20 weekly payment per child, previously given to all families with children. The government has also frozen the seniors additional tax deduction in nominal terms, and abolished it for future retirees. We have also just scrapped the \$10,000 a year university subsidy—so fees have increased by \$10,000 per student, per year. The typical fee to attend your local university is now typically \$15,000 a year, plus living expenses. In short, Britain—a democracy every bit as stable as that of the US—has no difficulty abolishing middle-class welfare.

## **Democracies are Different**

It is easy for people living in a stable democracy to think that all democracies are the same, and the problems with their democracy must be universal. But democracy is a complex thing, with any number of elements. For sure, elections are crucial, but they are by no means the only aspect of a democracy.

One strong difference between the US and UK democratic models is that US has a strong legislature, and a weak executive, whereas the UK has a strong executive and weak legislature. In Britain, the executive is drawn from the legislature. By and large, members of the legislature want to be members of the executive. And the way to become a member of the executive is to prove you are a team player—by voting the party line, time after time after time. Party discipline is (almost) absolute in the British parliament. A “three-line whip” on members of parliament requires a member of parliament to attend and vote in the way the party deems correct. Finance bills are always three line whips. Voting against a three line whip is a serious act of rebellion, and can be terminal for a politician’s career. The ruling party can—and sometimes does—expel members of parliament who go against a three-line whip, and can prevent them from standing under the party’s banner at the next election. In those circumstances, the chance of re-election is very slim, because British people overwhelmingly vote for party, rather than person. If all that is not sufficient, and the government still loses a vote, it can call for another vote on the same issue, declaring it a vote of confidence. Losing a vote of confidence causes parliament to be dissolved, and new elections to be held. You have to be a very brave and very determined member of parliament to vote against a government bill in those circumstances.

As a result, the British Prime Minister is an elected dictator in almost all matters. For sure, a truly ridiculous policy would lead to rebellion, but discipline is so tight that the Labour party—our left wing party, with many people committed to pacifism and disarmament—voted for the Iraq war. In that context voting to limit tax breaks for the middle class is an everyday event. No-one likes it, but if it has to be done, it has to be done.

Furthermore, voters in Britain like party discipline, and understand broad fiscal realities. Mrs Thatcher was famous for telling us—incorrectly, in truth—that running government finances was just like running the family finances. Under Blair, Labour realised that they had to “get it”, financially and economically, to get elected.

## **Civil Society at Work**

Here we are helped by civil society, and particularly by an independent body called the Institute of Fiscal Studies (IFS). The IFS, as it is always known, was created in the late 1960s by a group of financiers and tax experts who were appalled at some of the technically unworkable tax ideas that were becoming law. The purpose of the IFS—of which I am a member—is to expose politicians whose numbers do not add up.

The obvious comparison is with the Congressional Budget Office, but the IFS is totally independent, not part of government in any shape or form, and our media respects it. If the IFS say that the government—or opposition—are talking nonsense, it will be on the television news, and in all of the serious newspapers.

Remember too that our television news programmes—an important and sometimes under-rated part of the democratic apparatus—are much more aggressive in the way they treat politicians than their equivalents in the US. If the IFS criticise the government, the media will follow it up. They will invite the relevant minister to discuss it, and if they refuse, the news will report that they have refused. If they appear, the questions will be persistent. Ministers can and do end up looking fools if they try to defend the indefensible.

All of this increases the political cost to politicians of making poor fiscal decisions. Add in the fact that we have one finance bill a year, and that parliamentarians have no ability to add financial riders to unrelated bills, and we have a democratic system that generally delivers sensible fiscal outcomes.

Of course, our politicians would love to do what your politicians do, and so, at the margins they manage to get round the system. The worst one is creating off-balance spending items that come back and bite us later on. And we make mistakes—the ultimate one being Gordon Brown’s claim to have abolished boom and bust, and spending as though he really believed it.

### **US Democracy in an International Context**

What America needs is not a simple rule on debts or deficits. Nor should it shut down the federal government from time to time, or to fail to pay its teachers or bondholders. These things, frankly, bring the US into disrepute.

Instead, America needs something much bigger: to think through the way that its democracy works in international context. To be fair, this is something that all countries should do, but perhaps it is more pressing in the US than elsewhere. In Britain, we have had commissions to look at the future of Scotland, which made strong recommendations on what was required for effective governance.

To an outsider, American democracy suffers from a lack of party discipline, and an excess of conflict between different arms of government. Irrespective of whether you approved of the content of Gingrich’s *Contract with America*, the concept of manifesto commitments is a good one. But with them have to come incentives for individual members to stick to them, even when the decisions hurt their districts. That is hard, which is why the ability of the national party to deselect members may be the only way to overcome a natural inclination to support local pork barrel projects and tax breaks.

Once discipline is established, parties need to come up with intellectually coherent rationales for borrowing. DeMuth provides an excellent starting point. As he says, the ultimate reason is to defend the existence of the state. The British borrowed heavily in both World Wars, and that was seen as money well spent. The same is true for Roosevelt’s borrowing after 1941. Even in the nineteenth century, when Britain had a strong, essentially moral commitment to fiscal rectitude, debt peaked at over 250% of GDP after the end of the Napoleonic wars. It took a century to get it down to the sorts of levels that we think reasonable today.

## **Public Investment versus Public Consumption**

Today governments also borrow to invest in assets that yield a benefit to people in the future. It seems morally legitimate to take out a 10 year bond to finance street lighting that will last 10 years. Of course it is theoretically possible that people in the future will decide that they don't want street lighting, but the ex ante case is reasonable.

This cannot, of course justify bridges to nowhere. The Gravina Bridge should not have been built, period. The line between what should and should not be funded is, however, not always easy to deduce ex post, and often impossible to detect ex ante. Take, for example, the Reagan era military spending. DeMuth writes that this will be "remembered as the decade when America borrowed a trillion dollars and terminated the Soviet empire—Gingrich's "Contract with American excellent investment indeed". He may be right, but two issues stand out. For sure, Russia has let go of Poland, and its other satellite states, but Russia itself has not progressed in the way we might have liked, and its involvement along its southern border still has at least shades of empire. The Russian Empire has been limited, but we should surely question whether it has been "terminated". Second, others will make the case that to the extent that Russia collapsed, its collapse had nothing to do with the trillion dollars spent by America on armaments. It is perfectly possible to believe that Gorbachev realised that the Russian economic system simply didn't work. Economic growth had been falling for more than a generation, and nothing that had been tried, worked. Change had to come, just as De Klerk realised that apartheid was untenable, and Deng Xiaoping saw that capitalism was the only option for China. In this story, America's deficit spending on armaments was a coincidence, not a cause of Russia's decline.

Windfarms fall into the same category. We may look back and see our current decade as one in which we spent a trillion dollars despoiling our landscapes for what turned out to be no good reason. Or we may find out that we spent a trillion dollars and prevented climate change sufficiently severe that it would have materially worsened our lives. It could yet prove to be "an excellent investment indeed" or a waste of money. Democratically elected government can and must make those sorts of decisions. That is what they are there for.

DeMuth is absolutely right is to criticise politicians describing all spending as investment. As he says, it isn't. The definition of a good investment is one that yields a rate of return that exceeds the cost of capital. Useful bridges will clearly pass than criterion, bridges to nowhere will not. Defence and environmental spending are very hard to assess, although individual projects can be assessed relative to other similar items.

The greatest omission from DeMuth's essay, however, is the legitimacy of deficit funding for education. The reality is that the US is a rich nation, above all, because of the human capital of the American people. That is true both in terms of their formal schooling, and their willingness to believe that it can happen. Educating someone properly today yields returns to the state—via higher tax revenues, and lower welfare spending—for the rest of their working lives. Of course the link at an individual level is erratic. Some people will not enter the formal labour market, for good reasons or bad, while the requirements of the labour market can and will change over time. But taken as a whole there is a good case to be made that education is the single most important investment a state can make for its future. Not only does it have straightforward economic returns, but we also know, for example, that better educated parents are better positioned to equip

their child effectively in the pre-school years. The returns to good education are multi-generational.

This is not, of course, a call for open-ended government spending on education, but rather a plea for good evidence-based work on rates of return to education spending. There is great harm in raising the ratio of debt to GDP if the spending does not support GDP growth later. But equally there is great harm in lowering the ratio of debt to GDP if the savings now reduce a nation's ability to grow in the future.

Gladstone and his ilk believed that bequeathing a national debt to future generations was to steal from those not yet born. He was right. But to take away future prosperity by failing to invest in projects with good rates of return is theft in just the same sense, for it too makes our children and grandchildren poorer than they need to be. That is the trade-off that matters, and rate of return must lie at the heart of any sensible ability to distinguish between legitimate and illegitimate long term borrowing.

DeMuth is to be applauded for raising the issue of debt and democracy, but a strong democracy, equipped with a vigorous civil society holding politicians to account, and educating voters in a calm and sensible manner can deliver sensible policies broadly backed by evidence. A democracy that works well will deliver sensible debt limits by consent, just as it will deliver sensible policies in a range of other policy areas.

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