The Quarterly Journal of Austrian Economics

VOL. 20 | N^O. 3 | 266–276
FALL 2017

Book Review

Public Debt: An Illusion of Democratic Political Economy

Giuseppe Eusepi and Richard E. Wagner
Cheltenham, UK, and Northampton, Mass.: Edward Elgar, 2017, 192 pp.

Karl-Friedrich Israel

Professors Giuseppe Eusepi of Sapienza University of Rome in Italy and Richard E. Wagner of George Mason University have added another book to the already extensive list of literature on the political economy of public debt. The purpose of their book is to correct two major flaws in the existing literature. First, they argue that it is "pure illusion to treat a democratic regime as being indebted." Second, they try to show that it is "pure mythology to treat so-called fiscal policy as the means by which governments manipulate public debt to promote systemic stability" (Eusepi and Wagner 2017, p. vii). Surely, both claims will strike the average reader as bold and by no means self-evident. They require analytical

Karl-Friedrich Israel (KF_Israel@gmx.de) is lecturer at the Department of Law and Economics at the University of Angers, France.

substantiation and clarification of terms. What exactly is illusory and mythical about the indebtedness of democratic regimes and their fiscal policy? Eusepi and Wagner's analysis spans 164 pages separated into 6 chapters.

In the first chapter of the book, the authors provide a very brief overview and some fundamental criticisms of the conventional macroeconomic approach to fiscal policy and public debt. The legacy of Keynes's *General Theory* in putting deficit spending at the forefront of fiscal policy measures to promote macroeconomic stability and full employment is well known and has been widely discussed among modern economists. Eusepi and Wagner argue that treating "political activity as a balance wheel to offset changes in private activity is overwhelmingly at work in contemporary political economy" (p. 7) and critically add "that the image of the balance wheel reflects the hold of myth and not the power of logic and observation." According to the authors, underlying the balance wheel view is a "mythical" as opposed to a "realistic" type of theory, because it is merely "postulating" instead of actually "generating" the outcomes under consideration. In their view, the conventional "theory contains no explanation grounded in individual action that is able to generate the observed result." In other words, it lacks *microfoundations*.

The authors themselves draw the connection to the famous microfoundations debate in modern macroeconomics. However, following Kirman (1992), they argue that representative agent analysis has not actually solved the problem, but only added another layer of "mythical" thinking. In this respect, one might say that Eusepi and Wagner are close to the "ultimate in microfoundationalists," a label Hartley (1997, p. 107) used to describe Austrian economists in the Misesian tradition. Yet, the book is not a contribution to the latter, but rather to public choice theory.

The authors' main point of contention seems to be that fiscal policy and public debt do not actually serve as a balance wheel, regardless of whether policy makers should try to use it as such. They do not engage in prescriptive policy analysis. Rather, they try to explain fiscal policy as an emergent phenomenon. They argue that a theoretical framework for the explanation of policy measures that we observe around us must take due account of the actual institutional environment within which the relevant actors make decisions, and needs to abstain from idealizing assumptions about their underlying motives. Eusepi and Wagner put themselves in the tradition of *The Machiavellians* (Burnham, 1943), including Niccolò Machiavelli himself, Gaetano Mosca, Roberto Michels and Vilfredo Pareto, who did not idealize politics, but treated it, arguably more realistically, as a struggle for power. In particular, they build upon the work of Antonio de Viti de Marco.

The authors do not intend to contribute to modern macroeconomics, but explicitly to the political economy of public debt. They hold that a "realistic line of analysis […] cannot rest content with positing relationships among aggregate variables, for to proceed in this fashion is to make it impossible to generate insight into the causal forces that are in play within a society" (Eusepi and Wagner, 2017, p. 32). Moreover, they explain that what they call "realistic" analysis is akin to Peter Boettke's (2007) "mainline" in economic thought. The latter provides a broader and more encompassing perspective on social phenomena than conventional macroeconomics. It includes, for example, analyses of the relevant political regimes. In chapter 2, Eusepi and Wagner thus develop some preliminary thoughts on the differences between monarchical and democratic regimes as well as some implications for the analysis of public debt.

According to the authors, debt in monarchical regimes, where state activities are financed out of income from royal property, can analytically be treated just like debt in any individual case. Monarchs would certainly be more powerful than regular persons, but they remain individuals that manage their private property and take credit using their own property as collateral. The authors mention that the "macro literature contains many references to sovereign debt and the possibility of sovereign default" and claim that this "literature is reasonable for monarchical and dictatorial regimes, but it is not reasonable for democratic regimes" (p. 39). They argue that the "theory of choice is a useful framework for personal debt as well as for a monarch's debts. It is not, however, generally useful for democratic debt because democratic debt emerges through some institutionally governed process of interaction" (p. 38).

While democratic debt may indeed emerge out of a somewhat more complex process, in which many individuals, negotiations and political bargains are involved, it strikes the reviewer as a rather odd claim to deny that the theory of choice is a useful framework for its analysis. After all, taking out a loan to finance public expenses, or increasing taxes as an alternative, is always a matter of choice on the part of government officials, regardless of the political system. It might be true that the theory of choice as such does not tell us very much about the subject matter, but that would also be the case when analyzing the indebtedness of monarchical regimes. A detailed analysis of the structural differences, that is, the institutional circumstances and incentives, under which representatives of democratic governments on the one hand and monarchs on the other make decisions, is required. Different arrangements of property rights are in fact a key issue. Put differently, monarchical debt also "emerges through some institutionally governed process of interaction," although it is a very different one.

Eusepi and Wagner recognize the role of property rights and briefly discuss their relationship with taxes, the latter being the most important source of finance for democratic regimes. According to the authors, taxes represent an infringement upon private property rights or a transfer of property rights from private citizens to public officials, depending on what view of democracy is underlying the analysis. They move on, focusing mainly on the differences between the idealized version of democracy as self-governance, in which property rights are voluntarily transferred by consent, and its actual features in the real world, which include varying degrees of coercion. In reference to Schmitt (1996), they argue that power and subordination are relevant features of all political systems, but "democratic regimes generate mythologies that disguise that power by invoking an ideology of self-governance." However, "power operates all the same." (p. 40)

While this is a very important point, the authors overlook that the masquerade of power and despotism in democratic regimes is just an instance of a more general phenomenon that is not unique to democracies. Whoever is in power under whatever political system has an incentive to create and spread an ideological justification for their position in order to protect it. This is as true for democratically elected officials as it is for monarchs or dictators. Take North Korea and the personality cult around the Kim family as a timely example of a hereditary dictatorship.

In the third chapter of the book, the authors provide some further discussion of what characterizes the democratic process of political decision making. In particular, they suggest that an economy is better thought of as an "ecology" instead of an "engine." The former view stipulates a system that comprises multiple economizing agents and allows for a realistic analysis of the subject matter, while the latter view pictures an economy as a machine constructed for a specific purpose. It is congenial to the mythical mode of analysis in modern macroeconomics. Chapter 3 picks up some of the thoughts from the beginning of the book and provides a transition towards the analysis of public debt under two types of democracy that follows. The subsequent chapter focuses on what de Viti de Marco (1936) called "cooperative" democracy, an idealized system that reflects the consent of the governed and represents an analytical benchmark. Chapter 5 covers public debt under "monopolistic" democracy, a more realistic form of democracy, which generates "gains for some people by imposing losses on other people" (Eusepi and Wagner, 2017, p. 85).

At the core of their argument lies the idea that public debt in democratic regimes does not follow the same principles as private debt under private law, namely, the principles of private property and freedom of contract, precisely because public debt generally emerges at the expense of some people, that is, against their will. The authors claim that "public debt falls within the rubric of public law and public ordering," (p. 84) which operates differently, since it allows for coercive property transfers.

Chapter 4 starts with the benchmark case of public debt under the ideal of cooperative democracy. The conclusion should be straightforward, but is not drawn explicitly in the book. If state activities always reflect the consent of the people, there is no difference whatsoever between private law and private ordering on the one hand and public law and public ordering on the other. State activities would fall under the nexus of voluntary and mutually beneficial exchange relationships. In reality, however, the benchmark condition of consent is virtually never met. The authors still regard it as a useful point of analytical departure against which to compare real-world monopolistic democracies.

Eusepi and Wagner try to provide what they call a "canonical model of democratic debt" and explain that a

> truly explanatory theory of democratic debt within the framework of a cooperative state must be able to explain the emergence of public debt

> from an initial situation where such debt did not exist. The model of the cooperative state requires that we explain how a set of people might choose to create public debt, just as it must explain how a set of people will agree to tax themselves. Otherwise, all one can do is start with the existence of debt or taxation and assert that this prior existence reflects the consent of the governed because the analyst presumes that consensus is an inviolable property of democracy. (pp. 85–86)

Now, interestingly, the authors are of the opinion that a meaningful notion of public debt is very difficult to conceive even within a cooperative state, or at least, that it is not plainly obvious how public debt could emerge under such a state. This is surprising. Indeed, the assumption of perfect consent is entirely heroic when it comes to actual nation states as they exist, but if we decide to start with that assumption for analytical purposes, it is not very challenging at all to explain the emergence of public debt, that is, a debt contract for which all citizens of the state collectively pledge to pay back a loan plus interest over some period of time.

All citizens might agree, given their time preferences, that it is preferable to finance some desirable government project not out of savings and their current incomes, but via a loan that they promise to repay out of future income. In order for the people truly to be indebted collectively, the creditor must come from outside. Otherwise, only a subgroup of the people would be indebted while the rest would not. Analytically, there would be no difference between this case and, for instance, a married couple taking out a loan together to purchase a house. Of course, it is not the husband who gives a loan to his wife, or vice versa, but there has to be an external creditor for the couple to be collectively indebted.

The word tax might not be very helpful when describing the sum of money voluntarily given to pay back the loan, but this is a semantic issue, not a substantive one. In fact, all taxes paid under a cooperative state would be voluntary payments made because the expected benefit of the government projects so financed exceeds the opportunity costs from the individual perspective of every person in the community. We would be entirely in the realm of private ordering based on the principles of private property and freedom of contract. This is the implication of the assumption of consent, but it goes without saying that it is not "an inviolable property of democracy" in the real world.

Eusepi and Wagner do not provide such a general and simple analysis. Instead, they give the example of a town that by consent of the inhabitants decides to build a dam. They invoke all kinds of complications in the form of disagreements among the citizens about how to finance the dam. Some might prefer to pay the tax directly out of current income or savings. Others might prefer to take out a loan. In such a scenario, the town would of course not collectively go into debt. Only some citizens would, collectively in subgroups or individually. Other citizens of the same state might even become their creditors. This would not be an instance of public debt as described above.

Eusepi and Wagner argue that when the town's council decides to issue bonds to finance the dam, it would inevitably replace private ordering by public ordering (p. 88). However, the authors forget that under a cooperative system, it can do so only if every citizen gives consent. In such a case, we would remain within private ordering. What the authors convincingly convey, however, is that when we relax the assumption of cooperative democracy, which they implicitly do already in their discussion of the benchmark case, various problems with respect to public debt arise. These include that some inhabitants may be forced against their will to pay back a sum of money that government officials have borrowed to finance projects they themselves disapprove of. This precisely is the problem of political power.

The relevant question then is how can we approach the limiting case of cooperative democracy without coercion? Eusepi and Wagner make the important observation that as "a practical matter of democratic operation, the ideal of a cooperative democracy is surely limited to relatively small-scale democracies," which is why they work with the example of a town "that contains a few thousand people at most, and where people can easily and nearly costlessly move somewhere else if they choose to do so" (p. 86).

The obvious conclusion seems to be that the right of opting out of public programs, including full-blown secession for sub-communities, must be granted in order to approach cooperative forms of governance. However, the authors do not dwell on this point. It is ironic that these rights exist, for example, in the monarchy of Liechtenstein.

Approaching the cooperative state is not primarily a question of public debt. Yet, it is reasonable to assume that genuine public debt would be extremely low, if it existed at all, under a cooperative state. Again, the tiny monarchy of Liechtenstein has practically no public debt outstanding. The authors conclude the fourth chapter by claiming that "de Viti's ideal of a genuinely cooperative state is a limiting case that is difficult even to approach with respect to public debt, though it might be more easily approached without public debt" (p. 110). This might be true, but public debt ultimately does not seem to be a cause of non-cooperative or monopolistic governments. Quite to the contrary, it is, at least in its excessive form, one important effect of monopolistic governments. There are numerous problems involved in public debt, and it exists in such large quantities, because virtually all governments are monopolistic in de Viti de Marco's terms.

Chapter 5 explicitly turns to the analysis of public debt under monopolistic democracies. In reference to Mosca (1939) and Pareto (1935), the authors hold that for "the most part, actual democratic systems operate in monopolistic fashion, meaning that they entail the dominance of a relatively small number of people over larger numbers" (Eusepi and Wagner 2017, p. 111). The authors explain that "people differ in their interests in and talents for acquiring political power. Possessing and wielding power will be more attractive to some people than to others. In this setting, political activity will become the province of subsets of people within any geographical territory." Following Mosca, one might call this relatively small number of people the *ruling class*. For these people, public opinion and sentiment are the most important sources of power as explained, for example, in Wieser (1926) and de Jouvenel (1948). The characteristic feature of power, not only in monopolistic democracies, but in any political system, is that those who "hold positions of power can […] distribute costs and gains among the population over which they rule" (Eusepi and Wagner, 2017, p. 112).

According to the authors, debt contracts of monopolistic governments never reflect the will of all the people, but merely the will of some. Given that most actual states are monopolistic rather than cooperative it becomes clear what the authors could mean by calling public debt an "illusion." It is illusory to take public debt for what the generated ideological tale of democracy as self-governance would have us believe. Public debt does not emerge out of consent, but is imposed upon the people by the ruling class that has successfully provided "ideological formulations that resonate with voter sentiments, such that people can support measures they would have opposed had they engaged truly in logical reasoning" (p. 130). This could include increased deficit spending.

More precisely, the burden of debt is imposed on a subgroup of the people. After all, there are also supporters of deficit spending among the electorate, and it is strictly speaking impossible to say, whether their support for public debt truly stems from a lack of logical reasoning as Eusepi and Wagner suggest. As a matter of fact, it might stem from perfectly logical reasoning. It is of course possible to personally benefit, directly or indirectly, from public debt. The authors do not consider this possibility. They realize that public debt virtually always "creates both voluntary and involuntary debtors" (p. 153), but even more importantly it creates voluntary creditors, who bring themselves in a position to benefit from the government's power to tax. Others may benefit from public debt indirectly, when they become recipients of the additional government spending made possible by debt finance.

Under monopolistic democratic rule, public debt becomes a tool of power. Eusepi and Wagner correctly emphasize that it covers up a redistribution of wealth behind "illusory" slogans and "ideological images" such as "we owe it to ourselves" (p. 163). The authors point out that the bulk of public debt is in fact not even made explicit through the sale of bonds, but remains implicit in the form of other liabilities that the governments hold, for example, social security programs. They call this implicit public debt a "systemic form of collective lying" (pp. 138–141). They argue that it "is systemic and not personal lying because it is an emergent quality of a system of public ordering more than a quality of any politician, though it is also easy enough to find lying politicians, just as it is possible to point to lying business people for that matter."

However, it seems rather odd to call lying a quality of a system. Here, the authors have forgotten, for a very brief moment, their ultra microfoundationalist inclinations. It is always individuals that lie, and if the system of public ordering encourages lies for personal benefit and the benefit of selected parties, it will attract opportunistic characters ready to tell them.

In the final chapter of their book, Eusepi and Wagner conclude that "there can be no such thing as public debt in a democracy because a democracy is not a sentient creature." And furthermore, they claim that there "is no public that can pledge its wealth in exchange for credits from other people" (p. 163). Taken as such, these claims are exaggerated and slightly confusing. It is true that a democracy is not a sentient creature, of course, but neither is a monarchy. Democracies are composed of sentient creatures, if you like, and it is conceivable that they unanimously engage in a debt contract and pledge their wealth as collateral. It might be very unlikely to observe in any given community of a certain size, since such an arrangement would imply a socialization of personal default risk, but it is not impossible.

However, it is clear that much of the image of public debt, generated in ideological discourse is completely illusory. Professors Eusepi and Wagner have provided a fair number of arguments to substantiate this somewhat adjusted claim. The reviewer would hold that public debt is not an illusion of democratic political economy, but simply a very different creature from what it is made to be.

REFERENCES

Boettke, Peter J. 2007. "Liberty vs. Power in Economic Policy in the 20th and 21st Centuries," *Journal of Private Enterprise* 22: 7–36.

Burnham, James. 1943. *The Machiavellians: Defenders of Freedom*. New York: John Day Company.

Eusepi, Giuseppe, and Richard E. Wagner. 2017. *Public Debt: An Illusion of Democratic Political Economy*. Cheltenham, UK; Northampton, Mass.: Edward Elgar.

Hartley, James E. 1997. *The Representative Agent in Macroeconomics*. London and New York: Routledge.

Jouvenel, Bertrand de. 1948. *Power: The Natural History of Its Growth*. London: Hutchinson.

Kirman, Alan P. 1992. "Whom or What Does the Representative Individual Represent?" *The Journal of Economic Perspectives* 6, no. 2: 117–136.

Mosca, Gaetano. 1939. *The Ruling Class*. New York: McGraw-Hill.

Pareto, Vilfredo. 1935. *The Mind and Society: A Treatise on General Sociology*. New York: Harcourt Brace.

Schmitt, Carl. 1996. *The Concept of the Political*. Chicago, Ill.: University of Chicago Press.

Viti de Marco, Antonio de. 1936. *First Principles of Public Finance*. London: Jonathan Cape.

Wieser, Friedrich von. 1926. *Das Gesetz Der Macht*. Vienna: Julius Springer.