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The role of public debt in the 'new normal'

The Schumpeterian approach can be a basis for a fiscal policy shaped by the need to transform our economies to deal with future challenges

The crises of recent years have led to impressive paradigm shifts in fiscal policy. With the Recovery and Resilience Facility (RRF), the European Commission has been enabled for the first time to finance broadly based national investment programmes by borrowing on the capital market.

In Germany, the *Schuldenbremse* ('debt brake'), inserted in the *Grundgesetz* (Germany's 1949 constitution) after the 2008 financial crash, has been challenged by the *Zeitenwende* ('changed times') proclaimed by the chancellor, Olaf Scholz, after the Russian invasion of Ukraine a year ago. With a further amendment to the *Grundgesetz*, investments for defence can now be financed through debt using a *Sondervermögen* ('special fund') of €100 bn. There is also a debt-financed climate and transformation fund of €60 bn.

In the United States, the president, Joe Biden, has launched the Bipartisan Infrastructure Law, supporting additional infrastructure investment with $550 bn over the next five years; the Inflation Reduction Act, providing almost €400 bn for investments in energy, industry, environment and electromobility, and the CHIPS and Science Act, for which $280 bn is available. With the federal-government deficit forecast to be $1.2 trillion in the fiscal year 2023, one can say that all these measures are ultimately financed by debt.

Theories and their limitations

There has been growing academic interest in the role of public debt, mainly due to the low interest rates which prevailed in recent years. Yet one finds few theoretical foundations for fiscal policy in the 'new normal' — full employment, where the government is promoting the

environmental, energy and digital transitions through debt-financed public investment and industrial policies.

The state of thinking can be found in the new book by Olivier Blanchard, former chief economist at the International Monetary Fund, *Fiscal Policy Under Low Interest Rates*. This presents two theories for public debt, 'pure public finance' and 'functional finance'.

'Pure public finance' is based on the neoclassical theory which sees no role for government as investor. Public debt serves as an instrument for transfers to private households, thereby reducing the capital stock and economic growth. Positive effects are only possible with an over-accumulation of capital: when households save too much, the government absorbs a part of private excess saving and redistributes it as transfers for consumption.

What is lacking is a theory of public debt which is able to explain the role of debt-financed public investments under full employment.

'Functional finance' corresponds with textbook Keynesianism, which focuses on unemployment. With debt-financed public-expenditure programmes, tax reductions or direct transfers, the government increases aggregate demand until full employment is (re-)established. In essence, modern monetary theory (MMT) can be subsumed under this heading, as its focus is on guaranteeing full employment under decent working conditions.

What is lacking is a theory of public debt which is able to explain the role of debt-financed public investments under full employment. In a recent study, I try to close this gap with a theory of public debt which combines important insights developed by the influential early-20th-century economist Joseph Schumpeter.

Growth theory

Schumpeter's distinction between 'real analysis' and 'monetary analysis' is of central importance for classifying and understanding the theoretical approaches to public debt. Put simply, in 'real analysis' the monetary sphere is identical with the real sphere (which is unfortunately not made explicit in the literature). In 'monetary analysis' the real and the monetary sphere are conceptually separate, even if they interact with each other. While 'real analysis' shapes neoclassical theory and the 'loanable funds model' (incorporating credit), 'monetary analysis' characterises the traditional Keynesian investment-savings/liquidity-money (IS/LM) model and MMT.

A main difference between the two approaches concerns the 'crowding-out' effects of public debt. In the real analysis, due to the identity of the real and monetary spheres, public debt causes a real as well as a financial crowding-out of private investment. In the monetary analysis, the ability of the banking system to create credit and money out of nothing prevents a financial crowding-out, but under full employment real crowding out remains a challenge.

This is where Schumpeter's growth theory comes in. In contrast to neoclassical growth theory, this is not about ever-greater accumulation of a unit good for which there is an invariable 'production function', characterising the quantities of physical inputs and outputs. Schumpeter focuses on how available resources are used differently in innovative production processes: economic development is triggered by 'revolutionary' changes, in which 'spontaneous and discontinuous change in the channels of the flow ... forever alters and displaces the equilibrium state previously existing'.

Schumpeter's growth theory can be summed up quintessentially as: without a temporary real crowding-out, one cannot have dynamic economic development.

Schumpeter is aware of the crowding-out challenge for the real economy and its inflationary impulses ('credit inflation'). He sees this as however only a temporary phenomenon, which dissipates when the positive supply effects of innovative investments come into play. In his view, 'if everything has gone according to expectations', then 'the equivalence between the money and commodity streams is more than restored, the credit inflation more than eliminated'.

His growth theory can be summed up quintessentially as: without a temporary real crowding-out, one cannot have dynamic economic development. In fact, as major central banks (the European Central Bank and the US Federal Reserve) define their inflation targets for the medium term, there should be sufficient space for transitory inflation shocks due to Schumpeterian innovation. In his growth theory, the banker and the private investor are the driving forces of growth: 'By credit entrepreneurs are given access to the social stream of goods before they have acquired the normal claim to it ... It is only thus that the economic development could arise from the mere circular flow in equilibrium.'

Impacts for the Recovery and Resilience

Facility

This approach can be modified by replacing the capitalist with the 'entrepreneurial state', as described by Mariana Mazzucato. The justification for such a role of the state can be found in the large literature on industrial policy. The uncertainty of fundamental technological innovation, network effects and path dependencies, which make private actors stick to existing technologies, are particularly worth mentioning.

Industrial policy can also be justified by corresponding activities of major economies. China with its ambitious and, so far, successful industrial policy, largely financed by banks dominated by the state, offers an instructive example of a development strategy based on the concept of monetary analysis in the sense of Schumpeter and Mazzucato.

But the key features of the Schumpeterian approach can also be identified in the design of the RRF. The financing of the programme by the European Union removes the financial constraint for the individual member states. The focus on innovation is meanwhile provided by the requirement that member states dedicate at least 37 per cent of their RRF allocation to measures contributing to climate objectives and at least 20 per cent to digital.

The Schumpeterian design could be also used for the reform of the Stability and Growth Pact (SGP).

A report by the commission shows that so far both thresholds have been exceeded. A study by Maximilian Freier and colleagues regards this as a blueprint for further initiatives: 'Thus, the RRF could provide useful lessons for the economic governance framework and for a potential permanent fiscal capacity for the euro area in the future.'

The Schumpeterian design could be also used for the reform of the Stability and Growth Pact (SGP). So far, the SGP does not allow the debt financing of public investment (a 'golden rule'). This can be justified by the difficulty to define public investment and the risk that it might cause a 'deficit bias' among national governments. But one could think of a *project-based* golden rule: national governments develop future-oriented projects additional to their existing investment plans, the commission checks whether the projects fulfill these criteria and if the projects are approved, they can debt-financed with the SGP.

In sum, the insights of a Schumpeterian approach provide a theoretical basis for a fiscal policy in the new normal, shaped by the need to transform our economies to deal with the challenges of climate change,

disruptions in energy supplies, digitalisation and demographics. These challenges require massive investments — directly by the state or indirectly subsidised — which cannot be financed out of current government revenues.

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