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European Journal of Political Economy 23 (2007) 1088 – 1104

European Journal of POLITICAL ECONOMY

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Debt financing of public investment: On a popular misinterpretation of "the golden rule of public sector borrowing"

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Received 12 July 2004; received in revised form 2 September 2005; accepted 14 March 2006
Available online 22 June 2006

Abstract

In this paper I challenge the proposition that the golden rule of public sector borrowing is consistent with the principle of intertemporal allocative efficiency, in the sense that growth-enhancing public investment justifies a structural public deficit. I demonstrate that in the long run the social opportunity cost of debt-financed public investment exceeds the social opportunity cost of tax financed public investments. This result holds if the social rate of time preference is lower than the interest rate on government borrowing. Thus a benevolent government would use taxes to finance public investment. In the short run, debt financing is justified if public investment has a considerable growth effect on private consumption. This requires a corresponding initial undersupply of public capital.
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JEL classification: E62; H54; H60
Keywords: Public investment; Public borrowing; Golden rule; Budget rules; Stability and Growth Pact

1. Introduction

The budget problems of some member states of the European Union have initiated a controversial debate surrounding the Stability and Growth Pact. The Economic and Monetary Union's (EMU) fiscal rules – instituted in the 1990s to reverse a trend of accumulating public debt and to strengthen the credibility of the euro in its initial phase – has been criticized as inflexible, both as being an instrument of stabilization of the cycle and also as an instrument of

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doi:10.1016/j.ejpoleco.2006.03.006

supply side support. The outcome of this discussion is the recent change of the Stability and Growth Pact[1] that above all affects the implementation of the excessive deficit procedure.[2] In contrast to the earlier arrangement, exceeding the 3% reference value as the maximum value for the annual government budget deficit can be justified by a number of so-called "relevant factors", in particular public investment (see European Commission, 2005).[3]

The special treatment of capital expenditure points to the "golden rule of public sector borrowing". According to this fiscal rule, government deficit is accepted if accompanied by an increase in assets so that the government's net asset position does not deteriorate. Thus current expenditures must be covered by current receipts while for investment expenditure recourse to debt is allowed.[4]

The supporters of the golden rule argue that debt financing of public investment creates incentives for providing public infrastructure projects that contribute both to growth in demand and increased productivity (see DGB, 2003). Kopits (2001) proposes that the golden rule can be considered as a "growth oriented" fiscal rule that avoids placing an undue burden of compliance with certain types of fiscal policy rules on cuts in government investment spending. Debt financing of public investment is further considered to be in line with the benefit principle of taxation or – as Musgrave (1939) calls it – the "pay as you use principle", and thus is consistent with a fair intergenerational distribution (see Yakita, 1994). If current expenditure is financed through taxation and investment is financed through borrowing, current taxpayers pay for current spending but future generations bear the cost of borrowing, as it will be they who gain from investment.[5]

With respect to intergenerational fairness or the contra-cyclical demand effects of public investments, it does not greatly matter whether the government invests in public consumption durables such as operas or parks or in productive projects that generate growth and improve the private factor productivity. Nevertheless, the debate on the golden rule focuses on productive public investment. In particular, the special treatment of public investment in the Stability and Growth Pact is to some extent motivated by fear that the EMU fiscal rules are likely to depress the

[1] On 20 March 2005 the Ecofin Council adopted a report to the Heads of State or of Government entitled "Improving the implementation of the Stability and Growth Pact". On March 22nd and 23rd 2005 the European Council endorsed this report, stating that it updates and complements the Stability and Growth Pact.

[2] For further details, see Deutsche Bundesbank (2005).

[3] Article 104 (3) of the EC Treaty refers to public investment: "If a Member State does not fulfil the requirements under one or both of these criteria, the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State."

[4] In the United Kingdom and Germany the government's deficit-limiting budget rules basically follow the golden rule. The golden rule is part of the "Code of Fiscal Stability" introduced by the government in the United Kingdom in 1997. The code states that over the economic cycle the government will only borrow to invest and not to fund current expenditure (see HM Treasury, 1998). Emmerson et al. (2003) compare the UK's fiscal rule to the system used by countries that have adopted the euro. Article 115 of German Basic Law as well as the constitutions of the individual German states are also orientated according to the golden rule, although there are problematic aspects concerning the way this budgetary rule is implemented in Germany (see Deutsche Bundesbank, 2005). Kopits and Symansky (1998) cite other countries that introduced balanced-budget rules of the golden rule type.

[5] The aspect of intergenerational fairness was recently discussed by Balassone and Franco (2000) and Kato (2002). Buchanan (1967) and Weingast et al. (1981) discuss the topic from a political economy viewpoint. They argue that debt-financed investment projects are considered less costly by voters than tax financing. Therefore the financing instrument has a potential impact on the efficient level of public investments. Peletier et al. (1999) argue that a golden rule could help to avoid the tendency towards strategic underinvestment.

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