

Structure and Agency in International Capital Mobility

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4 Bonded Polity: The Distributional Consequences of Relying More Heavily on Bond-Financed Social Policies*

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Over the past decade, European governments have become increasingly indebted. High levels of unemployment and low levels of growth have meant that politically timid governments have built up larger and larger debt-levels to placate their constituencies. Rather than scale back the welfare state, or increase the tax revenue base with which to pay for programmes that the electorate has come to expect, governments have chosen the path of least resistance: paying for today's policies with tomorrow's revenues. This chapter looks at the more significant distributional consequences of the shift to debt-financed social programmes.

The chapter is divided into three sections. The first section looks at the justifications for moving to more debt-financed policies. People and states do not usually plan as a first course of action their future indebtedness; debt-financed policies are the best choice, given the alternatives. The second section presents an empirical slide of a single country's move from one funding path to the other. Countries, for the reasons mentioned in the first section, have switched from a tax and money-financed path to one which relies more heavily on debt-financing. Sweden is chosen for a case study as it exemplifies the trend common

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to other industrialized countries: Sweden is an economy saddled with large public policy expenditures; one which relied heavily on tax and money financing throughout most of the postwar era; and one which has recently switched over to debt-financing its fiscal policy ambitions.

The third section attempts to sketch the new distributional fault-lines that are expected to result from a shift from tax and money-financed to debt-financed public policy. It sets up a relatively simple framework based on the arguments and data that were presented in the first two sections. This depiction, though informed by the Swedish example, is intended for application to a much larger sample. Whereas the institutional framework of the contemporary welfare state was built over class cleavages, the new environment might provoke new lines of conflict, potentially threatening the welfare state edifice. Besides the potential inter-generational trade-off assumed by loan-financed fiscal policies, borrowing (both foreign and domestic) encourages new factorial and/or internationalist fault-lines – for which welfare-state institutions are not suitably prepared. In particular, I conclude by suggesting that the most likely outcome benefits investors holding mobile assets, at the expense of those holding domestic – more immobile – assets.

Why borrow?

Why have the industrialized nations chosen to rely more heavily on debt-financing? This first section provides an explanation for the change, proposing a foundation from which to survey the remaining empirical landscape. In particular, I argue that increased capital mobility has seriously undermined the arsenal of economic steering mechanisms available to government leaders. As autonomous monetary policies have been sacrificed on the EMU altar, more and more of the national burden is being borne by fiscal policy measures alone. Tax bases cannot be expanded for fear of potential capital flight, and as a result lending has become the only viable revenue source for maintaining the popular welfare state. In short, states have not chosen their debt-financed path because of the economic gains such a strategy might offer; debt-financing is the result of three interactive developments – the collapse of autonomous monetary policy options; the threat of capital flight; and the politics of entrenchment. These are the three rubrics under which the remainder of this section is organized.

Throughout most of the postwar era, the developed economies have leaned heavily on money and credit policy instruments to steer their domestic economies (in and) out of recessions. In an international

environment characterized by embedded liberalism, nations wielded relatively independent monetary policy instruments to maintain the growth levels which facilitated (and paid for) the development of modern public policies (Ruggie, 1982). The political pressures which formed the consensus at Bretton Woods were the same which drove national governments to adopt public policy measures for softening the blows of *laissez-faire* capitalism.

With the advent of freer (international) markets for capital, this regime has collapsed. While there is some disagreement about the impetus and reasons for the change, a near consensus has developed around the idea that monetary policies (and the monetary financing of fiscal policy), especially those of the smaller economies, have become much more costly in an environment characterized by increasingly free (financial) capital mobility.¹ If changes in the market itself cannot be held completely responsible for the absence of monetary policy autonomy, the European Union is providing its own pressures – though, arguably, the Union itself is conforming to the same market pressures. Over the most recent years, member-states of the European Union (and those on its periphery) have begun the pursuit of a single currency: a convergence path which, by definition, rules out monetary policy autonomy. In short, whether the changes are provoked by faceless market forces, or by those of the more impressionable Commissioners, European economies – in particular the smaller ones – have been under great pressure to jettison their autonomous monetary policies.

Obviously, autonomous monetary policies were not the only instruments available for maintaining economic stability in the postwar period; fiscal policies, generally, were widely and effectively wielded by industrial states. Why shouldn't these effectively fill the vacuum left by the jettisoned monetary policies?² Indeed, those who preach the benefits of freer capital markets often offer reconciliation (both implicitly and explicitly) in the form of increased fiscal policy effectiveness.³ Thus, in theory, there was hope that this new economic environment – characterized by increasing levels of financial capital mobility – would not threaten democratic controls on the economy. Not only were fiscal policies unhampered by increased capital flows, but they were considered to be all the more efficient under the new international regime.

In theory, maybe. In practice, the record of the industrial states has not been all that promising. Along with increasing capital mobility, the 1980s brought with it a radical reorganizing of national tax policies,⁴ which – despite the promise of greater ease, equity and efficiency – has

led to greater downward harmonization.⁵ Increasingly mobile factors of production have increased tax competition pressures. We might expect this downward pressure on revenues to lead to a corresponding pressure for reducing social expenditures, but the link is neither strong nor tight. In practice, what appears to be happening is the following. While there are decreasing real revenues available for social policy funding (because of the factors listed above), there has not been a concomitant drop in social spending levels. Instead, the ballooning gap between revenues and expenditures is being filled by government borrowing.

This international pressure for streamlining (in both monetary and taxation realms) has severely constrained the potential for government revenue generation. But the government budget constraint contains two elements: government revenues *and* expenditures. The third reason that states are increasing their debts is because of the electorate's unwillingness to jettison the public policy programmes for which their decreasing tax revenues are intended to pay.⁶

Recently, several authors have begun to study various political constellations used for the construction and defense of the welfare state edifice.⁷ These authors' basic argument is that the politics of welfare-state retrenchment is different from the politics of welfare-state expansion. In the words of Stephens *et al.* (1994, p. 3):

The broad social coalitions supporting the welfare state status quo prevent centrist and even right wing parties from implementing, or even advocating, significant cuts in entitlements. Thus, to the extent that economic difficulties mean the agenda in most countries is not expansion but rather retrenchment, one should expect narrower partisan differences than in the past.

We should expect the same sort of broad coalition to defend against cuts in the public policy edifice; there is, in short, little political gain to be made from carving up the welfare state. Public opinion is strongly in favour of maintaining the basic features of the contemporary welfare state, but its ability to control capital, to tax it, and to reap its benefits has decreased over time. In the short to medium term this vacuum is filled by borrowing. As a result, the burden of paying for these social benefits is now being borne more heavily by the average resident. As we will see in the third section below, the more mobile factors can escape taxation.

The Swedish record

Over the past decade, European governments have become increasingly indebted. Globally, government debt levels increased to more than 55 per cent of world GDP during 1981–93, from 45 per cent in 1960–72 (IMF, 1995, p. 208). High levels of unemployment and low levels of economic growth have meant that politically timid governments have built up larger and larger debt levels to placate their constituencies. Rather than scale-back public policy outlays, or increase the tax revenue base with which to pay for programmes that the electorate has come to expect, governments have chosen the path of least resistance: paying for today's policies with tomorrow's revenues.

To get a closer look at the nature of this regime-change, we now turn to the experience of a country that has been particularly hard hit by these events: Sweden. This section aims to quantify the discussions above by looking at developments in Sweden over the last decade. In particular, this section asks: Is it true that revenue sources have declined, while expenditures have largely remained constant? Has the gap been filled by increased borrowing? And who, exactly, is lending the money? Answers to these questions will provide a foundation from which to study the distributional dilemmas that result from them.

To begin with, we look at Swedish government revenues, expenditures and budget deficits over the last decade, which are shown graphically in Figure 4.1. As the first section hinted, revenues began to drop off from

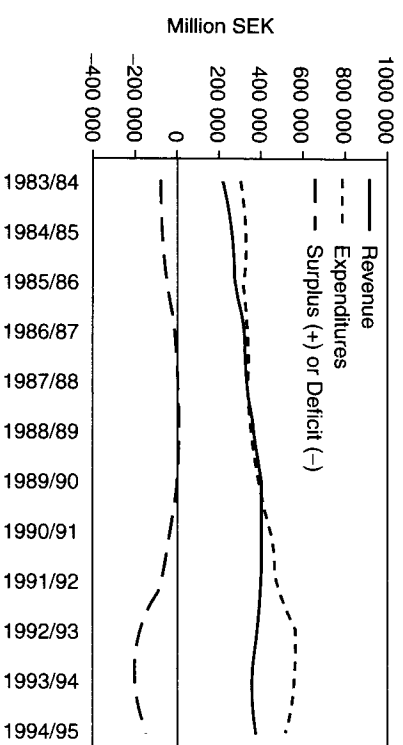


Figure 4.1 Swedish state revenues and expenditures, 1983–95
Source: Based on SCB (1995, table 269).

about 1989, while expenditures continued to grow. The result was a growing budget deficit, from about the same time. In per cent of GDP terms, government expenditures have stayed within a relatively small margin (between 25 and 30 per cent of GDP) over the past decade. Thus, there would appear to be strong political support for maintaining public spending levels, despite the drop in tax and money revenues.

Accumulated budget deficits become government debt. Thus, the difference between Sweden's falling money and tax revenues and its unchanging revenue level is reflected in the Swedish government's debt figures. Figure 4.2 details the extent of that debt over the entire postwar period. There are two significant elements depicted in Figure 4.2. First is the extent to which debt levels have grown since the mid-1970s; the level of Swedish public debt has grown to such an extent that it has surpassed the immediate postwar levels, and is setting new record heights.

The second significant element of Figure 4.2 is the growing degree to which foreign-denominated bonds make up the total debt burden. Foreign-denominated bonds now constitute approximately 30 per cent (and rising) of the total Swedish debt burden, and this reliance on foreign-denominated debt has unique distributional consequences which will be explored in the third section below.

With debt levels that are growing at unsustainable rates, it becomes important to ask about the cost of servicing this debt, and Table 4.1

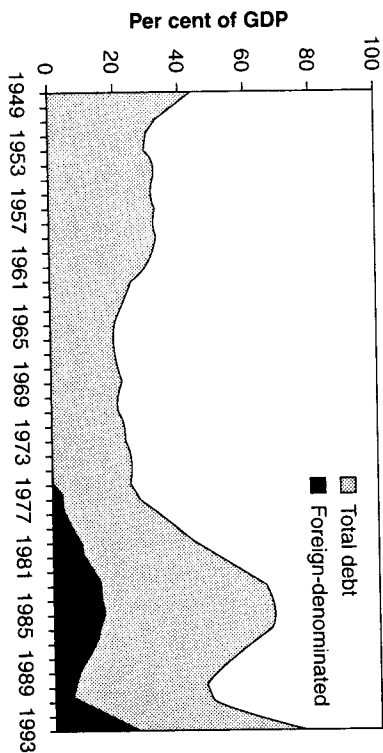


Figure 4.2 Swedish central government debt, 1949-93
Source: Based on Riksgäldskontoret (1977, 1994).

Table 4.1 Expenditures and incomes associated with Swedish state debt, 1983-93 (millions of SEK)

	Expenditures				Income				Net expenditures
	Interest on loans in SEK	Interest on loans in foreign currency	Realized exchange-rate loss	Other expends., net	Interest on loans in SEK	Interest on loans in foreign currency	Realized exchange-rate gains	Other income, net	
1982/83	33 990	9 744	4 414	453	262	28	115		48 196
1983/84	39 875	12 245	7 700	998	229	75	127		60 387
1984/85	45 651	13 975	15 053	1 312	129	58	570		75 234
1985/86	49 002	12 537	6 816	1 149	315	32	2 648		66 509
1986/87	51 432	10 027	3 628	1 226	374	96	2 031		63 812
1987/88	48 826	9 783	2 924	505	422	295	7 911		53 410
1988/89	45 059	8 314	2 821	840	585	130	3 140		53 179
1989/90	53 505	8 551	4 035	929	1 273	300	1 751		63 696
1990/91	57 835	7 333	1 870		3 131	346	2 217	311	61 033
1991/92	59 840	6 720	4 048		3 576	411	3 432	3 146	60 043
1992/93	66 838	19 474	46 036		6 173	429	43 459	9 197	73 090

Source: Based on Riksgäldskontoret (1994, p. 12).

measures the nominal weight of the debt burden. Swedish net expenditures from both foreign and domestically-denominated debt have been increasing over the last decade. Although there is some income generated as well, the net figures are surprisingly large. However, to really capture the magnitude of these expenditures, we need to compare them to other expenditure items for the Swedish government.

Table 4.2 lists the departmental expenditures of the Swedish government in the fiscal year 1992/93. In that year, the expenditures associated with the national debt totalled SEK 73 090.2 million. There are only two other departmental expenditure items on the whole 1992/93 budget that exceed this amount: those for the Ministry of Health and Social Affairs and those for the Ministry of Finance. In other words, more money went to servicing the national debt in Sweden for the 1992/93 fiscal year than went to the Ministry of Defense, the Ministry of Education, the Ministry of Labour and all of the other remaining government departments.

In concluding this section, there are three main elements of the debt-financed Swedish regime worth mentioning. First, and most obviously: the overall size of the debt-servicing burden is enormous. Government

Table 4.2 Swedish government expenditures, 1992/93

<i>State expenditures, by department</i>	<i>SEK millions</i>
I Royal Household and Establishment	65.0
II Ministry of Justice	18 646.1
III Ministry of Foreign Affairs	16 811.2
IV Ministry of Defense	38 641.6
V Ministry of Health and Social Affairs	133 043.6
VI Ministry of Transport and Communications	25 483.0
VII Ministry of Finance	124 039.5
VIII Ministry of Education	53 093.5
IX Ministry of Agriculture	8 457.4
X Ministry of Labour	45 989.5
XI Ministry of Cultural Affairs	14 639.4
XII Ministry of Industry	8 617.7
XIII Ministry for Civil Service Affairs	2 259.1
XIV Ministry of Environment and Nature Resources	2 008.0
XV The Riksdag and its agencies	649.8
XVI Interest on the national debt	73 090.2
XVII Unforeseen expenditures	13.6
Total	565 548.2

Source: Based on SCB (1995, table 274).

revenues used to service the debt are taken away from other public-policy areas. This, obviously, affects those who rely most heavily on current public policy expenditures. Second, the debt burden in recent years has been increasing at an alarming (and unsustainable) rate; it has become the current method of maintaining government expenditure levels. Third, and finally, it is noteworthy that a significant share of the Swedish debt is now being carried in foreign-denominated bonds. The remaining section looks at the distributional consequences of these changes.

Consequences of the regime change

As the first two sections of this chapter have discussed the reasons for (and the nature of) a fundamental regime change in the way in which countries fund their fiscal policy ambitions, this last section asks the more difficult question: What are the distributional consequences of this new regime? There is no easy answer to this question; indeed, there are several answers, each dependent on a multitude of variables. So where do we begin?

The previous two sections emphasized the degree to which debt was replacing other means of financing government expenditures, and the extent to which this debt was increasingly carried in foreign currency bonds. This seems like an appropriate starting point for our analysis: (1) what are the distributional consequences of a more debt-burdened public policy generally; and (2) what is the distributional significance of a growing *foreign* debt burden? From these two questions, I propose that three potential cleavages offer themselves: the first is an intergenerational divide; the other results from the price-trend effects that are a product of these changes; and the third cleavage goes across a spatial (internationalist) divide. These three potential cleavages are the organizing framework for the remainder of the chapter.

Intergenerational trade-offs

At first glance, the intergenerational consequences of a shift to debt-financed fiscal policy would appear obvious: tomorrow's generations end up paying for today's policies (of which, presumably) they obtain no benefit. But, as is often the case with intergenerational exchanges, first appearances can be deceiving. On closer inspection, the intergenerational consequences are far from clear-cut: those consequences can only be understood situationally and turn on (among other things) the generosity of the current generation in its bequeaths.⁸

Economists tend to discuss these issues in terms of the Barro-Ricardian Equivalence Theorem (BRET), despite the fact that Ricardo's musings on the matter were distinctly non-equivalent.⁹ As there is no agreement as to whether or not the BRET holds in theory and/or practice,¹⁰ it is difficult to trace the distributional consequences, among generations, of the policy shift. The potential intergenerational consequences of this change are dependent upon whether or not economic actors are benevolent and bequeath future generations with the means to pay off the debt. In economic theory, then, there may or may not be distributional trade-offs; in practice, however, we can say very little about its nature.

Nor can we say much about the apparent injustice associated with this intergenerational trade-off. Like economists, political philosophers cannot agree about the existence, let alone the nature, of intergenerational justice. Ball (1985, p. 322), for example, argues that "'inter-generational justice' is an oxymoron". What little work that has been done by social scientists on the issue of intergenerational trade-offs does not provide much guidance in our query.¹¹ In short, the social philosophers leave us with the same uncertainty and emptiness as did the economists.

Though we can say nothing with certainty about the specific distributional or just consequences (among generations) of choosing one regime over the other, we can say something about the likelihood of consequences from moving along the debt-financing path. What is certain is the fact that changes in the international economy have made debt-financing a more likely means of funding public policy ambitions. This was the argument of the first section. As a result, in this new environment, there are – *at best* – no intergenerational trade-offs: current generations bequeath future generations the money necessary to finance future tax demands on current borrowing. *At worst*, however, there will be hell to pay in the future. In short, we have moved to a path in which the likelihood of intergenerational trade-offs have increased, and yet we have neither the institutional nor the analytical approaches needed to accommodate them.

Price-levels: the regime consequence

The second distributional issue to arise in this new, debt-financed, regime is the tendency to move from an inflationary path to one emphasizing price stability and/or deflation. This change in price regimes has, in itself, distributional consequences. This section contains two parts. The first shows why the regime change encourages dis-

inflationary price levels; the second looks at the potential distributional consequences of this change.

Why disinflation?

If we contrast the postwar inflation trend with today's, one is struck by the enormity of the recent change. Inflation, today, lies at record low levels; but this in itself is not evidence that the new regime is anti-inflationary. The fact that growth rates are now at (historically) very low levels, is also a symptom of the same problem. Deflationary pressures might simply be the result of a decline in aggregate demand. Also, international capital mobility may be pressing down the price regime, as they migrate from continent to continent in search of better returns (Stewart 1983). Another, not necessarily exclusionary, argument is the ideological one in support of independent central banks – one which has been growing in currency over recent years. In short, there may be several explanations for why the price regime has become less inflationary over time; but I would like to offer another. In addition to the potential explanations above, we can expect that debt-based regimes – by their very nature – encourage deflationary measures.¹²

When a country floats a bond to secure finances for its public policies, the price that it will pay, the interest rate, is generally assumed to cover two elements of risk:¹³ the risk of default and the risk of devaluation. The market is said to evaluate the likelihood of these two risks, and set its price accordingly. The problem is, however, that there are no hard and fast indicators which telegraph the likelihood of these two risks. Generally, we assume that these risk elements are reflected in a series of economic variables which include (among other things) a country's inflation rate; the size of its budget deficit; its current debt level; its past record of exchange-rate adjustments; and so forth.

In particular, the market reads the following (rough) indicators as signals for creditworthiness: a low inflation rate; a small budget deficit; a small cumulative debt level; and infrequent exchange-rate adjustments. As states rely more heavily on debt-financing, creditworthiness indicators become increasingly important objects in the eyes of economic policymakers. When debt levels are large, and interest-rate payments take up a larger and larger share of the government expenditure pot, creditworthiness indicators themselves become high-priority objectives.

What, then is the result of a country pursuing these objectives? Obviously, they are disinflationary. Disinflation is the only acceptable response to creditors which are weary of past inflation. In addition, however, the size of the current and past budget deficits (that is, the

debt level) will need to be restrained to satisfy creditors. There are (as any first-year economics student is aware) two means to better these imbalances: constrain expenditures and increase revenues. To the extent that revenues are increased by taxation (without being reemployed in an asset-improving manner), there will be less capital remaining to invest in productive activities. With less capital available, investment and growth are choked: the preconditions for a disinflationary regime. Alternatively, should other public-policy programmes be pruned back, and these revenues are instead funnelled to service the debt, the result on the economy will be just as depressing (assuming, of course, that these public-policy measures had at least some demand-stimulus, or investment consequences).

Distributional consequences of disinflation

Thus, the sort of policies that are demanded by creditors are those which encourage fiscal discipline and price stability. Debt (whether domestically or internationally dominated), then, will pressure governments to pursue restrictive, disinflationary policies in their attempt to try and limit the size of their future interest payments. What, then, are the distributional consequences of a disinflationary regime?

In answering this question it would be a mistake to think that the current situation is novel. In many ways, the movement from an inflationary to a disinflationary path parallels the experience of the interwar period. In the 1920s several European countries were heavily indebted, and the question of public finances and the value of money was the topic of frequent discussions among policy-makers and economists. Indeed, J. M. Keynes' writings on the subject provide us with a useful vantage point from which to view the current situation.

In *A Tract on Monetary Reform*, Keynes (1971 [1923]) concerned himself with the distributional consequences of price regimes which were either deflationary or inflationary. To study this, Keynes introduced a three-part classification of society, which he believed corresponded to society's main interest cleavages. Keynes focused on what he referred to as the investing, business and earning classes – recognizing that the three classes overlapped, and that a single individual could engage in the activities of all three classes.

In summary, Keynes describes his argument as follows (1971, pp. 29–30):

We conclude that inflation redistributes wealth in a manner very injurious to the investor, very beneficial to the business man, and

probably in modern industrial conditions, beneficial on the whole to the earner. . . . On the other hand deflation . . . is liable, in these days of huge national debts expressed in legal-tender money, to overturn the balance so far the other way in the interests of the rentier, that the burden of taxation becomes intolerable on the productive classes of the community.

Keynes' particular interest was in finding the effects of changes in the value of money on these three classes. The move to a deflationary regime in the interwar period parallels the current situation. During most of the postwar regime, inflation became one of the most usual ways of paying for current social policy ambitions; with money-financing, social policy programmes could be paid for with relative ease. The distributional consequences of this, as Keynes pointed out, were to the benefit of the business and earning classes. The shift to a less-inflationary path, Keynes argued, would bring with it relative distributional benefits for the investing classes, at the expense of the more productive classes (that is, the business and earning classes). It is not an exaggeration to expect the same distributional consequences from a similar regime shift today.¹⁴

In short, Keynes pointed to the degree that shifting from an inflationary regime to a disinflationary regime brought with it a distributional trade-off that benefited the rentier at the cost of the more productive classes. This we can call the *regime consequence*. But to what extent are the distributional consequences limited to intergenerational and intragenerational (but intra-national) cleavages? The empirical section, above (p. 77 ff) showed that a growing share of the national debt is being floated in foreign-dominated bonds. Does the nationality of creditors alter the relevant distributional consequences?

To pay for the policy ambitions of public officials, Keynes argued that there were three means of payment: an inflation tax, depreciation and/or a capital levy. The third and final section of this chapter will look at the distributional consequences that result from choosing one repayment option over the other. It is the argument of that section that the divisions which appear can be best understood in terms of a domestic-international cleavage. Choice of one repayment scheme over the other will benefit internationally-oriented or domestically-oriented interests.

The spatial divide

A third potential line of conflict involves a domestic/international divide; a cleavage which may seem quaint in a world with relatively free

factor mobility. Nevertheless, elected governments are not (yet) mobile, so the domestic/international divide remains politically salient. Indeed, I have argued elsewhere that governments are spending more time and energy concerning themselves with the development of economic environments more suitable to international investors, at the expense of their domestic constituents (Moses and Tranøy, 1995). International interests have become powerful actors in national political arenas.

In order to consider the spatial cleavages that result from the new debt-based regime, we need to consider the problems associated with asset mobility and the growing tendency on the part of industrialized countries to rely more heavily on floating bonds in foreign-denominated bonds (as was seen in the Swedish case above). The internationalization of both creditors and debtors provides us with a matrix of potential spatial (that is, international/national) cleavages. One way to trace out these cleavages is to reconsider the three means of debt-repayment (following Keynes), and the two main types of debts incurred by nations today. In other words, there are six potentially different aspects of the new lending regime which bring to the surface the internationalist cleavage. These are shown in Figure 4.3. The text which follows takes up each repayment option in turn.

Future taxes

Under current international economic conditions, future taxes are the most likely option for paying off the national debt. With greater factor mobility, and falling support for utilizing autonomous monetary policies and adjustable exchange rates (at least in Europe), this line of cleavage will potentially become the most significant. Here the main distributional trade-offs will be between mobile and immobile (both long-term and short-term) assets. Taxing authorities will feel international pressure to harmonize national tax levels on the most mobile assets. Revenue

Payment options	Bond-type	
	Domestic-denominated	Foreign-denominated
Future taxes	Mobile/Immobile assets	
Devaluation	Domestic/Foreign investors	Investors/Government
Money	Domestic/Foreign investors	Investors/Government

Figure 4.3 Spatial cleavages

short-falls will be supplemented with an increased tax burden on those assets unable to escape. In other words, land-owners and labour (although over the long run, taxes on these may converge as well) will be burdened with a heavier share of the tax burden, as the more mobile capital assets are able to reap the benefits of public policy while avoiding most of its costs. This mobility cleavage remains the same regardless of whether the original debts were incurred in domestic or foreign currencies.

Devaluation

Despite all the problems associated with devaluations, Keynes' advice to a heavily indebted interwar France was to devalue away large parts of its debt-burden (1971). His argument was not only based in terms of general economic effects, but also because it was the most politically expedient (though the distributional consequences are far from egalitarian). Elected governments may find it cheaper (politically) to pursue the devaluation option. This is true in part because a devaluation benefits domestic (that is, voting) bond-holders more than it does foreign bond-holders.

If the debt is domestically-denominated and there are some foreign holders, a devaluation benefits the domestic holders at the expense of international holders of the government's debt.¹⁵ The reasons for this are as follows. For foreign holders of domestically-denominated bonds, a devaluation means an immediate depreciation of their return. Although this is a relatively easy way for governments to decrease their tax burden, it does contain credibility costs which makes its frequent use more costly. For domestic holders of domestic-denominated bonds, however, the devaluation does not affect their return, as it consists of nothing more than a nominal (scalar) change – the relative value of the debt has not altered. Indeed, the devaluation might actually aid the domestic holder of bonds if the devaluation contributes to bettering the general economic environment in which the domestic holder resides.

With the increased use of employing devaluations as a means to pay down debt, the market cover on the devaluation part of the risk increases. This is the primary reason that governments begin issuing debt in foreign currencies: to convince the market of their commitment to maintain fixed exchange rates.¹⁶ With foreign-denominated bonds, the government itself bears the full brunt of the costs of a devaluation.¹⁷ International creditors are unaffected by the change; and domestic holders of internationally-denominated bonds actually benefit from the devaluation.¹⁸ In other words, the cleavage lines in this scenario (with foreign-denominated bonds) are between the government and domestic investors.

Money

Previously, this chapter (p. 84 ff) described the distributional consequences that result from a move from an inflationary to a disinflationary path, and touched on the distributional benefits of money-financing. There are, as pointed out, *internal* cleavages along factorial lines which are affected by the move from inflationary to disinflationary financing paths; the question now asked is, are there any spatial cleavages that might also result from the two different debt types?

In a scenario with domestically-denominated bonds, inflation can be used by the government to inflate away the real debt.¹⁹ In other words, the debt can be repaid in inflated currency units (that is a currency unit of relatively less worth). Although this is not the best alternative for domestic bond-holders, as already discussed, it is not the worst alternative either. Inflation, *ceteris paribus*, is a scalar adjustment.²⁰ For international holders, also, the host (domestic) inflation level is of little consequence until inflationary pressures eventually pressure an exchange-rate change. At this point, the consequences of a devaluation kick-in (see above). In other words, the spatial cleavage lies dormant until inflationary pressures bring about an exchange-rate change. At this point, the lines of cleavage parallel those found in the previous, devaluation, scenario.

Alternatively, if the bonds are denominated in a foreign currency, the potential winners and losers of inflation are otherwise. In this scenario, the government does not benefit by domestic inflation, and it can actually be hurt should the inflation lead to a devaluation. At this point, as with the devaluation scenario above, the government bears the full cost of the devaluation. Alternatively, foreign holders of this debt are not affected by the host inflation, regardless of whether or not it ends in a devaluation. Finally, domestic holders are positively affected if the inflation eventually leads to a devaluation (see above), but are otherwise agnostic. In short, the distributional consequences along the spatial axis parallel those in the devaluation scenario.

To conclude this third section we should mention that these three options, under the spatial divide, are not equally likely in the current international economic environment. There is a greater likelihood that the first option, future taxes, will be the most likely one for paying off the growing debt burden. In this scenario it matters little if the debts are denominated in domestic or foreign currencies, the result will be a burden borne most heavily by the least mobile assets. To the extent that other two repayment scenarios are possible, the currency denomination

of the bonds becomes more significant. In these scenarios (money and devaluation), the main distributional cleavages will be between different nationalities of investors and/or between investors and the government.

Conclusion

The argument of this chapter has proceeded in three steps. In order to examine the distributional consequences of a move to more debt-financed public policy ambitions, we needed to first look at the reasons for, and nature of, this new regime. The first section explained the current development in terms of a change in the international economy which limits government revenue options. In addition, on the expenditure side, we looked at the political difficulties associated with pruning public policy expenditures. The result, the first section argued, was a ballooning public debt.

The second section looked at the specific nature of the debt problem in one country: Sweden. In Sweden, revenues were constrained and expenditures maintained as we would expect given the argument in the first section. The second section detailed a new Swedish revenue regime, with two main characteristics. First, the debt-level which has developed in Sweden was shown to be quite large and costly. Second, Swedish debt is increasingly being held in foreign-denominated bonds.

The third section of the chapter has looked at the distributional consequences of this new regime. From the two unique elements of this regime (the very size of the debt burden and its international nature), I have proposed three potential lines of distributional cleavage: intergenerational; investor-producer; and spatial.

There is little we can say about the potential intergenerational cleavage. Simply said, a move to a debt-financed regime has increased the likelihood that there are some intergenerational cleavages. The exact nature (and existence) of that cleavage depends on the specifics of the situation. The rentier-producer divide was first illuminated by Keynes in the inter-war period. The change to a disinflationary price regime, which is partly a consequence of debt-dependency, benefits the investing classes at the expense of the productive classes. We can expect the same general consequences from the current regime change in so far as it mimics the interwar period.

The final, spatial, cleavage is the most difficult to map. International cleavages are found at the nexus of the various repayment means and debt types. To the extent that autonomous monetary policies (and thus,

devaluations) have become less-utilized, we can expect that future taxes will be the primary means of paying off the current debt burden. If this is the case, we can expect that the future tax burden will be borne most heavily by those assets that do not have recourse to exit, regardless of the nationality of the creditor.

In the other two scenarios, however, the denomination of the bond has significant distributional consequences, depending on the government's plan of action. To the extent that the bonds are denominated in the domestic currency, governments can pursue the money-financing and devaluation paths as means to paying off their debt. In doing so, they themselves and their domestic investors benefit from the policy, at the expense of international investors. On the other hand, to the degree that debts are being increasingly held in foreign-denominated bonds, governments are increasingly subject to the potential costs of devaluation (even if they are not politically instigated), and forced to rely even more heavily on future taxes as the main means of repayment.

To the extent that postwar policies are understood as a compromise among competing, relatively equal class interests, these policies may become threatened by the new cleavages which result from a greater reliance on debt-financing. In the most likely scenario, mobile assets – particularly among the investing classes – will end up reaping the distributional benefits of a regime which is disinflationary and increasingly reliant on an overburdened tax base. Immobility, domestic producers have the most to lose.

Notes

- 1 See, for example, Goodman and Pauly (1993), Notermans (1993), Moses (1994, 1995b), Andrews (1994) and Helleiner (1994).
- 2 Herein lies another distributional quandary. Although, in theory, one can expect macroeconomic substitutability, different people, classes and sectors benefit more from monetary policy (say, interest-rate steering) than with fiscal policy measures. In short, there are also distributional concerns here which might be considered in the future.
- 3 This argument is furthered by evidence of policy variations among states within a monetary Union (e.g., the USA), as well as by economic theory based on the so-called Mundell–Fleming conditions. With international capital mobility, fiscal policies should be even more effective as the probability of ‘crowding-out’ diminishes significantly.
- 4 Indeed, the 1980s has been heralded by several as ‘The decade of tax reform’. See, for example, Pechman (1987), Boskin and McClure (1990) and Steinmo (1993).
- 5 Although marginal individual and corporate tax rates first come to mind, the logic is equally consistent when applied to other types of taxes. Cross-border

shopping will almost certainly reduce international VAT differentials; tax rates on mobile labour are bound to equalize, given greater labour mobility; etc.

- 6 Though I focus on demand-side measures for explaining public-sector growth and entrenchment, I recognize other supply- or finance-side arguments as equally legitimate. They only bolster my argument about the difficulties associated with decreasing expenditures.
- 7 See, for example, Pierson (1994, 1995), Huber and Stephens (1993), Stephens (1994) and Stephens *et al.* (1994).
- 8 I would like to thank Tim Sinclair for challenging me on this point and referring me to Eisner's (1994) work on the subject.
- 9 See O'Driscoll (1977). Ricardo's discussion on these matters can be found in Ricardo (1951, 1, pp. 244–9); and his *The Funding System* (*ibid.*, 4, pp. 149–200).
- 10 See, for example, Leidemman and Biejer (1988), Poterba and Summers (1987), Stern (1987) and Dornbusch and Fisher (1994, pp. 587–93). The article which renewed interest in Ricardo and the subject is Barro (1974).
- 11 As far as I know, the intergenerational literature is more or less confined to the social scientists working in overlapping-generations economic models (e.g., Blanchard and Fischer, 1989; Sargent, 1987; and Stokey and Lucas, 1989); those working on public investment and state-owned enterprises (e.g., Arrow and Kurz, 1970; Freeman, 1989); those in the field of sustainable development (e.g., World Commission on Environment and Development, 1987; and Mahnes, 1990); and a few curious social philosophers (e.g., Barry, 1978; Ball, 1985; and Coleman, 1990). A surprising exception is Lindbeck *et al.* (1994, pp. 164–7).
- 12 This is, of course, the inverse of Fisher's (1933) famous argument.
- 13 I believe that there are other, more ideological, factors involved when ranking a bond's creditworthiness. See Moses (1995a) for details of this argument.
- 14 One might object to the description of the earning classes benefiting from inflation, but – if anything – to the extent that wages and salaries are now largely indexed, it is not unreasonable to argue that earning classes benefit all the more (than during Keynes' time) from periods of inflation. Obviously, the specific benefactors of an inflationary regime are difficult to pinpoint with precision.
- 15 This distinction between domestic and international bond-holders is subtle in a world with free financial capital mobility. Still, investors have residence, even if their capital doesn't.
- 16 Indeed, this is one of two solutions offered by the influential Lindbeck commission (Lindbeck *et al.*, 1994, p. 47): issue foreign debt and employ debt-indexing.
- 17 Consider a government which has incurred X amount of debt in foreign currency f . At a 1:1 exchange rate, the domestic currency, d , is equal to the foreign currency; i.e., $d = f$. After a 10 percent devaluation, the government will still own Xf , but it will need to pay them off in d units, where f is now equal to 1.1*d*. In this way the government carries the brunt of the devaluation.
- 18 Consider a domestic investor which invests the amount X of domestic currency, d , in a foreign-denominated bond, under the same conditions as in the

previous note (i.e., $d = f$). After the government devalues its currency by 10 per cent, the investor's original investment 1*f* is now worth 1.1*d*. If we assume that the domestic investor will exchange her foreign-denominated bonds back into the domestic currency, she has made, *ceteris paribus*, a 10 per cent profit.

19 With progressive tax schedules there is also the possibility of using inflation to encourage 'bracket-creep' revenues. See Steinmo (1993, p. 19).

20 Again, at the risk of labouring the point, I am not ignoring the issue of whether an investment in some other, more real, form would have been more profitable. The investing classes benefit relatively less than other classes under an inflationary price regime.

5

International Capital Mobility: An Endogenous Approach*

Timothy J. Sinclair

Whether we are ready or not, mankind now has a completely integrated, international financial and information marketplace capable of moving money and ideas to any place on this planet in minutes. Capital will go where it is wanted and stay where it is well treated. It will flee from manipulation or onerous regulation of its value or use, and no government power can restrain it for long. (Wriston, 1992, pp. 61-2)

Rhetoric like this is the talk of our age. Capital mobility is the new Leviathan, and there is not a lot we can do about it, or so we are told on TV and by tabloid newspapers. Many serious commentators also seem to think international capital mobility (ICM) has reduced democratic governments to shadows of their former selves (Strange, 1996). Other scholarly critics, however, dissent, suggesting this view is significantly exaggerated. For these writers, ICM remains partial, constrained by public authority (Andrews and Willet, 1997; Watson, 1999). So, who is right here? Is international capital mobility as powerful and important as often portrayed, or is its importance overstated?

The impact of ICM has become an important contemporary political issue because it is widely perceived to threaten national economic sovereignty as this political framework developed during the Keynesian Welfare State (KWS) era subsequent to the Second World War (Martin,

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