Does National Debt Matter? - Analysis Based on The Economic Theories

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Abstract

The national debt has been increasing at a higher percentage than the GDP of the United States. Since the 2008 Global Financial Crisis, national debt increased dramatically since the country borrowed to finance its expenditures. Moreover, with the onset of the Covid-19 pandemic, national debt increased to 105% of the GDP. There have been worries about whether the national debt is a matter of concern, and many theories have been developed to explain national debt. The classical economists advocated for a balanced budget where taxes finance government expenditure. Keynes argued that governments should borrow to finance their spending to avoid a decrease in demand. The pecking order theory argued that when businesses use all their retained earnings, they should prefer debts to equity to finance their expenditures. Trade-off theory advocated for financing through debt because it is cheaper. Debt payments of a company are deductible through tax, and less risk is involved when taking debt than equity. Finally, the neoclassical economists assumed that government debt has a one-time maturity and pays the current interest rate. Using the concepts of these theories, it is clear that national debt should not be a matter of concern because it is cheaper to pay debt than equity and debt benefits a country in the long run.

Keywords

National Debt, Inflation, Economic theories on debt

1. INTRODUCTION

The national debt is the representation of the amount of money the government has borrowed from the public and is yet to pay back. Economists have differed on national debts and whether it is something to be worried about or not. Alexander Hamilton argued that national debt was a way of building the nation, and if it is not in excess, it will be a blessing (Hannah, 2021). President Andrew Jackson, however, differed with the idea and argued that national debt was a curse, and he tried to eliminate the debt through paying. Jackson used federal funds to pay debts, and by 1837, the national debt was fully paid (Hannah, 2021).
United States' national debt has been increasing and decreasing since World War II. During the Global Financial Crisis in the year 2008, the national debt rose by a high percentage. Debt began to grow at high rates after the crisis surpassed economic growth. The covid-19 pandemic caused debt to grow even higher as governments borrowed to curb its spread, and economies were crossed. US national debt has been projected to rise to 117% of the GDP by the Responsible Federal Budget Committee due to slow economic recovery from the Covid-19 pandemic (Hannah, 2021).

There are varying reasons why the national debt is a matter of concern and why it is not. The national debt is not a matter of concern because financial institutions are strong, taxing authorities are maintained, and the country's long-run productive capacity is secure. Low-interest rates on bonds and securities will enable the nation's economy to be sufficient since investors will not be afraid of the debt (William, 2019). On the other hand, the national debt is a matter of concern because of various reasons, which include there will be a deficit in the dollar, interest costs will increase, investments are at risk, the government will be less flexible in responding to crises, and incomes will be lower leading to fewer economic opportunities (Peter, 2019).

2. ECONOMIC THEORIES ON DEBT

Economists have come up with several theories to explain debt. This section will consider the pecking order theory, trade-off theory, classical theory, neoclassical theory, and the Keynesian theory on public debt.

**Pecking Order Theory**

Pecking order theory states that a business should prioritize financing themselves internally by using retained earnings, but if unavailable, they should do so through debt or equity. When the business finances itself through debt, it signals that its management is confident of paying its obligations (Evan, 2021). Business managers prefer using debt to finance the business over equity because the cost of debt is usually lower than the cost of equity and debtholders usually require lower returns. According to this theory, national debt is not a matter of concern. This theory advises governments to borrow when retained earnings are unavailable since debts are cheaper to pay as compared to equity. However, this theory does not give a guide on how to calculate the costs of financing.

**Trade-off Theory**

Trade-off theory states that a company chooses how much debt finance and equity finance it will use through balancing its costs and benefits. According to this theory, debt increases in a risk-free interest rate and when the tax code allows more generous interest rate tax deductions (Hengjie, Murray & Ali, 2021). It states that, the price of debt will be at equilibrium when there is a decrease in the tax benefit and an increase in the risk-free interest rate.

Using the trade-off theory, financing through debt is cheaper because debt payments of a company are deductible through tax, and less risk is involved when taking debt than equity. Trade-off theory however, predicts a positive relationship between earnings and leverage which contradicts empirical evidence that shows a negative relationship between the two variables. Inspite of the negative relationship, national debt is not a matter of concern since it will be cheaper to pay it through deductible tax.

**Keynesian Theory of Public Debt**

Keynesian theory for public debt states that increasing public debt does not increase interest rates so long as policy can successfully manage the psychology of the debt market (Tony, 2018). Keynes argued that increased government spending through taxes and loans positively impacts the economy since it increases capital (Andrey, 2021). According to Keynes, maintaining aggregate demand was a solution to evade long periods of unemployment, weakening demand, causing companies to lay off workers.
Therefore, Keynes argued that governments should borrow to finance their spending to avoid a decrease in demand.

The Keynesian multiplier effect states that an increase in government spending will improve the economy. Government spending will increase the employment rate, increasing the Gross Domestic Product by a large percentage (Andrew, 2021). This theory advocates for an increase in the budget deficit during a recession not taking into account that borrowing causes financial crowding out. However, according to this theory, national debt should not be a matter of concern because it improves the economy in the long-run using multiplier effect.

Classical Theory of Public Debt

According to Smith, governments should not run budget deficits because debt accumulation damages the economy even when owed to domestic investors (Lefteris, 2007). Smith argues that the government will increase taxation to pay the debt, causing domestic capital flight and currency devaluation. He advocated for a balanced budget where government expenditure is financed by taxes.

Ricardo developed the Ricardian Equivalence Theorem, which states that taxation and public borrowing have equivalent forms of financing government spending. He argued that if the government resorts to borrowing, it will have to repay the debts in the future through high taxation (Lefteris, 2007).

Classical economists advocated for overproduction whereby demand and supply should be at equilibrium which is threatening to economies. Therefore, national debt should not be a matter of concern because it increases demand and provides for additional demand in the economy.

Neoclassical Theory of Public Debt

Neoclassical economists assumed that government debt has a one-time maturity and that debt pays the current interest rate. Therefore, investors and wealth owners will be willing to hold debt and physical capital in their investments. It should be assumed that the ratio of debt to labor is held constant by financing part of the interest through additional debts and the remaining through taxes (Diamond, 2010).

Neoclassical theory depends overly on mathematical approaches missing the empirical study. However, national debt should not be a matter of concern because according to this theory debt pays the interest rate.

3. CONCLUSION

National debt has been on the rise in the recent years in many economies. The 2008 Global Financial Crisis made countries to borrow to finance their expenditures hence the rise in national debt. The COVID-19 pandemic worsened the situations causing a further increase in national debts. However, from the analysis above, it is clear that national debt is not a matter of concern. National debt improves the economies in the long-run according to the Keynesian multiplier and debt is cheaper as compared to equity.

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