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Musgrave, Ralph S.

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Government borrowing is pointless where a Government Issues its own Currency.

Ralph Musgrave.

Abstract.

The alleged justifications for government borrowing in a country which issues its own currency are examined here. The conclusion is that no justification exists for borrowing money in the normal sense of the phrase "borrow money": that is, the use by one entity of money loaned by another entity, and so as to fund expenditure by the first entity. In contrast, and where a deflationary stance is required, it is justifiable for government (or as is more usual, the central bank) to borrow in the sense of withdrawing funds from the private sector and purely so as to stop those funds being spent. Moreover, inflation destroys a proportion of the money "borrowed". Plus government effectively confiscates (via tax) the money needed to pay interest on this "borrowed" money. This is essentially a money shredding operation. This is not the normal meaning of the word borrow.

Many of the points made here apply to the central bank of a common currency area. Individual countries within a common currency area are not considered.

Keywords: Abba Lerner, Modern Monetary Theory, government borrowing.

Correspondence: Ralph Musgrave, 24 Garden Avenue, Framwellgate Moor, Durham, DH1 5EQ, England. ralph "at" fram "dot" ndo "dot" co "dot" uk

Introduction: the lack of justifications for government borrowing.

One of the main alleged justifications for government borrowing is that it helps regulate aggregate demand: Keynsian "borrow and spend". This justification makes little sense, as is shown below. Other justifications for borrowing are thin on the ground: they are a long way from being backed by a string of economics Nobel laureates.

I have three standard economics text books used by first year university students, each with six to eight hundred pages (Alchain (1974), Lipsey (1999) and Sloman (2000). "Borrow and spend" apart, the only justification given in these books for borrowing is that governments sometimes find themselves unexpectedly short of income. This argument, plausible as it sounds, does not stand inspection, as is shown below.

Hundreds of articles and papers have been published which deal with government borrowing, and which go into numerous complex issues related to government borrowing. Borrow and spend apart, none of them seem to address in any depth the basic question as to why governments borrow.

There is even a book advertised as specifically addressing this question (McDonald (2006)). Two reviewers (see Note 1 at the end) claim that McDonald "starts with some fundamental questions: Why do governments borrow...."

These reviewers are wrong. McDonald's work is a well researched HISTORY of government borrowing, but does not answer the above fundamental question.

Abba Lerner and Milton Friedman.

The idea that government borrowing makes little sense is not new. Friedman (1948: p.250) makes this suggestion.

And Abba Lerner is widely credited with being one the first to claim that government borrowing is pointless in that funding government expenditure is not the main purpose of government borrowing.

The arguments below do not attempt to improve on Lerner's ideas: rather, the purpose is to consider the alternative ideas, that is the conventional and alleged justifications for government borrowing, and to show that they do not stand inspection. Put another way, the objective is to show that Lerner's ideas do not face strong opposition.

Tax and print money.

The fundamental weakness in the idea that governments need to borrow is the fact that governments have access to almost limitless funds from tax (plus a smaller source of funds: money printing or "seigniorage").

Some advocates of borrowing might want to answer this by turning the latter argument on its head. That is, why not argue that tax is questionable given the extremely large sums that governments can borrow?

The answer to this is that in the long run, say ten years or more, the vast bulk of government funds inevitably come from tax. That is, in recent decades, most countries' national debts have hovered very roughly around half of GDP: that is about one twentieth or less of total funds that the government of a typical country needs over a ten year period. And debt to GDP ratios much more than the above "half" are regarded by markets as undesirable.

Given this lack of importance of borrowing in the long term, the question arises: why borrow at all? That is, the onus is on advocates of borrowing to justify themselves, not on the advocates to tax to justify themselves.

Money Printing.

Having claimed above that government borrowing needs to be justified because of its relative insignificance, the same charge could be made against money printing. The justifications for money printing relied on here are the conventional or text book ones, which briefly are as follows.

First, as an economy expands in real terms it will require a larger money supply (in real terms). Second there is a consensus that inflation of about 2% is optimum. Thus the amount of printing needed per year (assuming growth of say 2%) will be roughly 4% of a country's monetary base (2% + 2%).

Also it makes sense for governments to vary the proportion of funds they obtain from tax as opposed to money printing, depending on the circumstances. And this proportion can vary dramatically: the monetary base expansion of both the UK and US in 2009 was unprecedented and this was the correct response the current recession. And conversely, if this expanded monetary base looks like contributing to excessive inflation in say 2011 or 2012, this may warrant a monetary base contraction as dramatic as the above mentioned expansion.

Moreover even the above dramatic monetary base increase was not enough, according to some, e.g. Galbraith (2009) and Tavakoli (2009).

In contrast to the above claim that the monetary base should be expanded in a recession, there is of course Milton Friedman's argument that governments are so hopeless at organising counter cyclical measures that it would be better if they did not try. This is doubtless a good point, on the other hand, given a serious recession, the political reality is that governments cannot stand by and do nothing.

The closed economy assumption.

It is assumed here, unless otherwise stated, that we are dealing with a closed economy. This assumption is not too unrealistic: that is, most of the arguments below apply to open economies, but in slightly altered form.

For example as regards national debt, about three quarters of the UK's national debt is in the hands of UK nationals, not foreigners. And even to the extent that UK national debt IS held by foreigners, this is approximately balanced by the amount of foreign government national debt held by UK nationals.

The US is obviously different in that other countries, China and Japan in particular, hold around half of US national debt at the time of writing. However, this is a recent

development. It was not till around 1995 that foreign holdings of US debt rose above the 20% level. However, in view of this large recent rise in the proportion of US government debt held by non-US entities, there is a section below devoted to the question as to whether it makes sense for governments to borrow from abroad.

The flawed justifications for government borrowing.

Various alleged justifications for government borrowing will now be examined, and in no particular order.

Riley (2006) gives two reasons or sets of reasons for government borrowing. The first is thus.

"Government borrowing can benefit economic growth: A budget deficit can have positive macroeconomic effects in the long run if it is used to finance extra capital spending that leads to an increase in the stock of national assets. For example, higher spending on the transport infrastructure improves the supply-side capacity of the economy promoting long-run growth. And increased public-sector investment in health and education can bring positive effects on labour productivity and employment. The social benefits of increased capital spending can be estimated through use of cost-benefit analysis."

The first flaw in this argument is that governments do not HAVE to borrow in order to fund capital projects. As already pointed out, they can easily fund such projects via tax. Indeed according to Kellerman (2007), the "social opportunity cost", (as Kellerman calls it) of financing public investment via borrowing is normally higher than via tax.

As to Riley's points about "long run growth" and "cost-benefit analysis", these are irrelevant. It is obviously true that capital projects should pass cost benefit tests, and that if they pass such tests, "long run growth" should ensue. But neither of these points in themselves are arguments for any particular method of financing government.

Does borrowing facilitate aggregate demand management?

The second justification for government borrowing given by Riley is the popular one mentioned near the outset above: Keynsian “borrow and spend” is allegedly a good way of managing demand.

However, there is a HUGE problem here, namely that there is a large amount of argument as to what extent “borrowing and spend” actually works. For example, it is plausible that “borrow and spend” does NOT influence demand because of the well known “crowding out” effect.

On the other hand it is equally plausible that borrow and spend DOES raise demand in that this activity may get a relatively slow moving money supply moving. (The velocity of circulation of money fell 72% in New York between 1929 and 1932).

But given the large uncertainties surrounding borrow and spend, it is almost lunatic to use this tool at all. And another absurd aspect of “borrow and spend” as a means to stimulate an economy is that the “borrow” part is quite clearly deflationary. Now if the objective is to stimulate or reflate an economy, what is the point of doing something which, at least to some extent, has the opposite of the desired effect?

The purpose of having a bath is the clean oneself (forgive the statement of the obvious). Is there any point in throwing dirt into the bathwater before climbing in? Obviously not. “Dirt”, so to speak, is the opposite of “clean” is it not?

Conclusion: given the uncertainties surrounding “borrow and spend”, this is a strange policy to adopt. It would make more sense either to employ interest rate reductions, or to concentrate on the part of “borrow and spend” which quite clearly DOES have an effect, that is the “spend” part. Put another way, “print and spend” is a far more logical policy (a sentiment shared by Hillinger (2010: 3 & 21).

The latter policy is effectively what the UK “government / central bank machine” did in response to the recession in 2009. That is the UK national debt expanded by around £200bn in 2009; but around ninety nine percent of this sum was quantitatively eased. Thus the net effect was simply to print £200bn. (Any readers not clear on this point please see note 2 at the end).

Extinguishing money.

“Borrow and spend” is allegedly a way to boost demand, but as was shown above, there are big question marks over this policy. That is, straightforward “print and spend” would be more certain in its effects.

This raises an apparent problem. When economies overheat, governments need to adopt a deflationary stance. If government borrowing is abolished or severely curtailed, one of the main traditional methods of damping demand, namely interest rate increases, might seem to have been destroyed.

The answer to this alleged problem is that no criticism is being made here of another activity, sometimes called “borrowing”, namely a central bank raising interest rates, and enforcing this interest rate rise by announcing to the markets that it will pay a higher percentage by way of interest to anyone wanting to “lend” funds to the central bank.

The difference between the latter and more normal borrowing is that nothing is done, or at least nothing SHOULD be done with the money so attracted. Indeed, the mere fact of doing nothing with such money means that the money is to some extent extinguished or shredded, because the longer the money is “borrowed”, the more does inflation erode its value.

In addition, while this takes place, the “government central bank machine” effectively confiscates money from the private sector to pay for interest on the “borrowed” money.

To expand on the latter point a little, where a central bank pays interest on “borrowed” money, the money for this interest must come from somewhere. Since central banks normally make a profit, which is normally handed over the government periodically, the money for the above interest will simply reduce this profit. That is, government’s income is reduced, which in turn means less government spending on roads, schools etc. Alternatively, if spending on the latter is to be held constant, then taxes have to be raised.

To summarise, both the OBJECTIVE and to a greater or lesser degree the actual EFFECT of the above operation is simply to confiscate money from the private sector and destroy it. This is not “borrowing” on any normal meaning of the word.

Finally, there is the problem that higher interest rates attract money from abroad and interest has to be paid on this. This represents a real cost for the country concerned. On the other hand, this problem occurs just as much with borrowing in the conventional sense of the word, so this is not a problem specific to “borrowing with a view to shredding”.

Does borrowing make those who benefit from the associated investment pay for such investment?

Many government financed investments (roads, hospitals, etc) endure at least a generation, and sometimes a century or more. Obviously it would be fair to make those who benefit decades in the future from such investments pay their fair share. And on the face of it, one way of doing this is to finance such projects with borrowed money, and gradually pay back the capital sum. This way, future generations do as much “paying back” as the current generation.

But there is a flaw in this argument: it is a plain physical impossibility to have future generations produce the concrete, steel and so on needed to build roads or bridges this year or next. And having new born babies or the as yet unborn supply labour to build roads and bridges is a problem too!

The only way to have future generations in one country to pay for today’s investment would be for the country to borrow the capital sum from some other country, and gradually pay the money back, as pointed out by Musgrave (1939: 269). (That is not me, nor a relative!).

But if every country adopts the latter policy, it becomes self defeating.

Moreover we all benefit from investments made by previous generations where the relevant debt has long been paid off. For example one very large investment of this sort is education: capital costs apart, these costs are normally born and paid off

annually (e.g. teachers' salaries). Thus trying to allocate the costs of investments to each generation in any sort of accurate way is a bureaucratic nightmare. It is probably simpler just to accept that each generation inherits huge benefits from previous generations, and that each generation should "leave the world as it found it", that is fund and pass on a roughly equivalent amount of investment to succeeding generations.

To summarise, having future generations pay for the investments they inherit is, first, almost a physical impossibility, and second, even were it possible, the idea is probably more trouble than it is worth.

Does borrowed money come from the wealthy?

An attraction of borrowing for politicians is that most of them probably think that borrowed money comes from the cash rich or the wealthy. Certainly politicians who want to ingrate themselves with the majority of the electorate, that is those on average incomes or less, will be attracted by this idea.

The above is a plausible idea: after all, where can government possibly get cash from other than those with cash to spare? However, there are flaws in this argument, as follows.

When interest rates are raised so as to attract funds to government coffers, there are three potential sources of funds: 1, additional saving by lenders, 2, forgone borrowing by borrowers, and 3, idle cash or an increased velocity of circulation of money.

As regards the last, No. 3, there is a big problem. As already pointed out, where this source of funds operates, the effect is an increase in aggregate demand. And we are not concerned with increasing demand: we are concerned to have government borrow and increase its spending OTHER THINGS BEING EQUAL. That is, the assumption is CONSTANT demand.

Thus to the extent that increasing interest rates does increase the velocity of circulation and hence increase demand, this will have to be negated by further rate

rises combined with the money shredding type of borrowing. Indeed this simply reflects the brute physical fact, already pointed out, namely that, increased consumption by government must be matched by reduced consumption by the private sector. Thus No. 3 is ruled out as a source of funds.

That leaves Nos 1 and 2, that is, additional saving by lenders and forgone borrowing by borrowers.

Taking lenders first, it is implausible that this reduced consumption by lenders takes place, plus the evidence seems to support this implausibility. That is, lenders (just like the rest of the population) are well aware that interest rates constantly rise and fall. Thus given an interest rate rise, are they really going to forgo their annual skiing holiday so as to put the money saved into the bank and get an extra £5 a year of interest next year?" And £5 is about all they would get.

It seems far more likely that any reduced personal consumption is effected by borrowers, not lenders. Amongst other reasons this is because it is much easier for borrowers to make large and sudden reductions in borrowing than for lenders to make large and sudden increases in saving. For example postponing borrowing money with which to buy a new car, and instead running the old car for a year or two is easy. Indeed, a large number of would be borrowers did this in the early part of the current recession, and car manufacturers were in trouble as a result, though this problem was alleviated by various "cash for clunkers" schemes later on.

In addition to households who forgo loans, given a small interest rate rise, some firms will do likewise, that is, postpone or abandon investments. And as with households, this is easy to do: at least it is easy in the sense that it does not take a genius to abstain from arranging a loan to buy some machinery.

Moreover, the evidence seems to support the idea that interest rates have little influence on saving. See Japelli (2002) p. 12).

As to borrowing, Martins (2003) found that household borrowing is strongly influenced by interest rates. Alessie et al. (2005) found the same.

A second flaw in the idea that borrowed money comes from those with cash to spare, is that whoever forgoes consumption in order to fund government will ipso

facto reduce the incomes of those who would have supplied the relevant goods had this consumption taken place. To illustrate, households which abstain from ordering new kitchens because they cannot afford the finance will reduce the income and consumption of those running and working for kitchen improvement firms, and the latters' suppliers.

To summarise, both the evidence and the theory seem to indicate that additional borrowing by government is funded mainly by reduced borrowing by the private sector, rather than by increased saving by the private sector. Thus it does not seem to be the cash rich who fund government borrowing. But even if this claim is wrong, the whole question as to who forgoes consumption when government borrows rather than taxes is certainly complicated.

Another political argument: passing the buck to successors.

In addition to the above argument about making future generations pay a fair share of the cost of investments, there is the similar argument (popular with politicians, no doubt), namely that borrowing somehow "delays the day of reckoning". Unlike the above "investment" argument, this "buck passing" argument could be applied to current as well as capital spending. That is, borrowing might seem like a way of bestowing favours on the current electorate, while leaving the allegedly difficult task of repaying the debt to successor politicians and future taxpayers.

Indeed, there is evidence that the motives for borrowing are political, rather than properly thought out economic reasons. Roubini and Sachs (1989, p. 931) show that the higher the number of parties in a coalition government, the higher is public debt. Put another way, a single party with a decent majority can afford to engage in "tough love" (or what appears to be tough love), that is, raise taxes so as to repay national debt.

The flaw in this "buck passing" idea is the "physical impossibility" point (set out above). That is, the real sacrifice is made while the spending that corresponds to the money borrowed takes place: and it makes no difference whether the expenditure is of a capital or current nature.

To illustrate the latter “current” point, there is no way of having those who will be born in 2015 make a contribution to generating electricity that is consumed in government offices in 2010. Moreover, this “physical impossibility” point should show up, as it were, in the economic theory. And it does, as follows.

Take an economy which is working at capacity or full employment. Regardless of whether an item of government spending is financed by tax or borrowing, there is no way the materials for this investment can be obtained other than by withdrawing resources from the rest of the economy. That is, given that the economy is at capacity, additional demand for materials and additional demands on the labour market will simply be inflationary.

In short, the “buck passing” idea is nonsense.

Appearances versus reality.

There is of course a possible weakness in the above claims that borrowing rather than tax brings little benefit for politicians trying to ingratiate themselves with the electorate. This is that the electorate may THINK borrowing is preferable to tax.

However the objective here is to deal with reality, not with the electorate’s ideas as to what constitutes reality.

If the electorate is deluded, the electorate needs educating. A properly functioning democracy involves, first, the electorate having a good grasp of the reasons for government decisions, and second, the electorate expressing its views on such decisions.

The sudden large expenditure argument.

One fully justifiable reason that households or firms borrow is that they do not have the cash to make purchases that are large relative to their annual income. For example someone buying a house will typically spend around three to five times their

annual income on the purchase. That is a very good reason to borrow: indeed, in most cases there is no option BUT to borrow.

Government, in contrast, is in a totally different position. The TOTAL of government spending on capital projects per year is an almost entirely predictable sum which is much less than half of total government income. Moreover, while some investments (like power stations or motorways) are certainly large, the construction and thus the expenditure normally take place over several years.

Does the erratic timing of tax receipts within each year justify borrowing?

Governments do not receive a constant amount from tax each month. And government spending can vary in a similarly erratic manner from month to month.

This leads some to claim that governments need to borrow during those parts of the year when receipts from tax are on the low side and/or spending is higher than normal. The quick answer to this is that given a short term lack of income, government can easily print money; then, a few months later, when income exceeds spending, government can do the opposite, that is rein in money and extinguish it.

It could be claimed that the latter money printing would be inflationary. However, there are flaws in this argument.

First, inflation is unlikely to take off just because the money supply is more than optimum for three months and then an equivalent amount below this level for the next three months.

The next flaw involves Ricardian equivalence of a sort: that is, where a private sector entity knows there is a £Y tax liability in the pipeline and has sufficient cash to meet this liability, that entity is unlikely to blow the £Y on frivolities.

This argument gains support from examining what might be called the counterparties to the regular annual government shortages and surpluses of income. These counterparties are very definitely not the sort of people who might blow a temporary excess of cash.

For example a significant proportion of people living on benefits might spend any temporary excess cash; however a large majority of these people (at least in the UK – pensioners or those on invalidity benefit) receive a fairly regular income from the state and thus do not cause erratic changes in government net income.

As to a slightly more responsible or talented or lucky section of the population, employees, this section of the population also has a regular income. As to income tax, this is deducted from wages and salaries, both where wages are paid weekly and where paid monthly (at least in the UK). Thus this section of the population does not contribute much to changes in government income either.

Finally, the sections of the economy which really cause the irregularities in government income are corporations and the self employed. These sections of the economy (at least in the UK) pay tax on profits once or twice per year. And there are penalties for late payment. However, it is precisely this section that is least likely to blow a temporary excess of cash. Any corporation or self employed person with a propensity for this sort of behaviour will not last long in business.

Conclusion: the variations in government net income through the year are not a reason for government to borrow.

Open economies.

In view of the large amount of US national debt which governments and other non-US entities have bought in the last decade, the question obviously arises as to whether government borrowing from abroad makes sense.

Where the private sector in a particular country finds that foreigners are willing to lend at a rate of interest below the prevailing rate in the country concerned and makes use of this cheap finance, this is a straightforward free market transaction. Unless there is are reasons to suspect market failure, there can be no objection to this transaction.

As to whether it makes sense for the GOVERNMENT of the relevant country to borrow from abroad, the excuses are weak in the extreme, because as has been

shown in the above paragraphs, the various alleged reasons for government borrowing no not stand inspection. At least, there are no good reasons for borrowing in the normal sense of the word, i.e. “attracting funds to finance expenditure”.

Moreover, if a government DOES borrow from abroad, this inevitably reduces the amount it needs to raise from tax or borrowing from domestic sources. Thus if a government does implement this policy, it is effectively just acting as an intermediate between foreign lenders and domestic private sector borrowers. And it is not government’s job to do this. That is, if a citizen or corporation in a particular country needs to borrow, it is up to the relevant citizen or corporation to sort out the best deal, and not expect government to do this job or even influence the decision, unless market failure can be demonstrated.

No borrowing means no liquidity traps.

There is not perfect agreement amongst economists as to what a liquidity trap is, but it will be taken here to mean a situation where a recession persists despite zero or near zero interest rates, and no more can be done (at least with interest rates) because they cannot be reduced any further.

Certainly interest rates are at the time of writing at or near zero in several major economies, there has been much discussion as to whether we are in a liquidity trap. The only option in this scenario, according to the conventional wisdom is borrow and spend. But as explained above, there are doubts as to how well borrow and spend works.

That leaves a third option: print and spend which is guaranteed to work. Given constantly rising cash holdings (or declining debts) in the hands of households, such households must at some point begin to spend their newly acquired wealth. The average building site labourer has worked out that when people win a lottery, they tend to spend the proceeds, though it seems a significant proportion of economists have not worked this out.

In contrast to the economists who do not realise that people tend to spend cash windfalls, there are a host of economists who have grasped this point and who thus

advocated channelling stimulus directly to households right at the start of the current recession, e.g. Spilimbergo (2008, section 16, p. 6) and Surowiecki (2009).

The serious mistake argument.

Government plans regarding total expenditure and the total collected via tax for a particular year can go badly wrong. For example the total collected via tax can turn out to be much less than anticipated. In this event, is borrowing justified?

Given the above mistake, the mistake should be rectified with as little dislocation to the economy as possible. This means, in the case of inadequate income from tax, upping taxation as quickly as possible.

Changing the source of government revenue results in a series of other changes to the economy: changes in the pattern of supply and demand for various products, for example. This means people having to change jobs, and learn new skills in some cases. This in turn means a temporary rise in the “natural level of unemployment” or the “Non Accelerating Inflation Level of Unemployment”.

If changing the shape of an economy, or changing the patterns of supply and demand are deemed to be in the long term interest of a country, no objections can be raised. But it is undesirable to make these changes, for example by having a significant portion of government income come from borrowing in one year, only to abandon or reverse this change next year. For example when interest rates are altered, this means dislocations for the building industry because house sales are heavily dependent on the ease with which people can get mortgages.

And raising or lowering taxes at short notice should not be difficult. The UK temporarily reduced VAT during the current recession. And a payroll tax holiday has been widely advocated as a way of getting the U.S. out of its recession.

Conclusion.

There is little reason for government to borrow money in the normal sense of the phrase “borrow money”: that is, using someone else’s funds to finance spending (capital or current spending).

In contrast, there is another possible use of the word “borrow”. This consists of government (or more usually a central bank) attracting money away from the private sector with a view to doing nothing with such money, apart from shredding as much of it as possible. This is not the normal meaning of the word borrow. This latter policy is justified where a deflationary stance is required.

Note 1.

The two reviews of McDonald’s book which claim that McDonald addresses the question as to why governments borrow are thus: 1, http://www.2think.org/debt.shtml and 2, the publishers, MacMillan: http://us.macmillan.com/afreenationdeepindebt.

For a longer and better review by *Jonathan Dolhenty*, see: http://www.radicalacademy.com/bookreviewmacdonald.htm

Note 2.

Government borrowing and spending £Z consists of the following three stages. 1, government borrows £Z. 2, government gives £Z worth of government securities to those it has borrowed from. 3, government spends the £Z on the usual items: schools, roads, etc.

Quantitative easing (assuming it is government securities that are quantitatively eased, rather than private sector securities) consists of the central bank printing £Z and buying back the above £Z of securities.

Thus quantitative easing cancels items 1 and 2 above. Thus there is only one net effect: item 3. That is, the only net effect is “government prints and spends £Z”.

Of course there is one other “net effect” namely that the central bank is left holding £Z of government securities. I.e. the government supposedly “owes” the central bank £Z. But this is a nonsense: both institutions (government and central bank) are owned by the people.

To call these securities a “debt” is as nonsensical as saying that shifting £10 from your left hand trouser pocket to the right hand trouser pocket means the latter owes the former £10.

Indeed, in the particular case of the UK, the Bank of England, is legally owned by the UK Treasury. That is the Treasury owns all the shares in the Bank of England.

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