What Ever Happened to Public Finance?

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I recall being in a public finance course when a fellow student asked the question, “can the U.S. government go bankrupt?” The professor replied, “Absolutely not--if there was a printing press in your basement, would you ever have to claim bankruptcy?” Since the students in the class were Ph.D. candidates who have already been exposed to other economic courses in macro/monetary theory, many questioned whether such an approach would be inflationary and diminish the value of money. “Not if unemployment is high and demand is insufficient,” the professor responded. At the time, this made perfect sense to me and quite frankly, it also makes perfect sense today. Now, more than ever, the political milieu seems to tend toward the notion that whatever is true for the individual, is also true for the whole, e.g., if we all must “tighten our belts” during a recession, then the government should also do so.

In addition to the bankruptcy question, there were other topics regarding taxation, fiscal policy and debt that I recall learning in public finance. One of the “generally accepted truths” of deficit spending maintains that in the short-term, government spending creates no wealth or income because private spending is “crowded-out,” dollar-for-dollar, by public spending. This tenet has managed to survive the years, despite the fact that it has been shown in the public finance literature that “crowding-in” is also a possibility, and notwithstanding the lack of definitive empirical evidence for the support of either. Another popular credo is that in the long-term, a larger debt will always place a greater burden on future generations.
What does public finance have to say about the short and long-term burdens imposed by debt financing upon the private sector? Well, if all resources are fully-utilized in the economy, then more public goods mean less private goods. The opportunity cost (or short-run burden) of more government is the loss of private goods as more of the economy’s resources are devoted to the production of public goods. However, if there are unemployed resources, then there is really no significant burden in the short-term because nothing has to be given up and the multiplier effect will result in proportionately larger increases in the production of both public and private goods.

In the future, if the debt is “owed to ourselves,” then there is no real burden in the long-term because paying the future interest and principal on the debt amounts to a redistribution from taxpayers to bondholders. If Treasury securities are owned internationally, then a future burden results from interest payments flowing out of the country to foreign bondholders. Between 1989 and 2006, the proportion of foreign-owned debt has increased from about 20 percent to 50 percent. From 2007 to the present, the foreign-owned proportion of Treasury securities has been about four (4) percent higher on average in each period than the domestically-owned proportion, although they have been trending back towards each other since 2009--probably due to the increasing savings rate of U.S. households.

Given that in the future there will most definitely be a debt “burden” as interest on the National debt is paid internationally and hence less income is available for future generations, a more cogent issue here is whether or not the U.S. would be able to sustain these payments over the long-term. The interest paid on foreign-owned
Treasury securities and U.S. GDP is plotted in Figure 1 from 1960 to 2010 (quarterly, in log units).

In the long-run, the U.S. will be able to continue paying interest to foreign debt holders as long as the difference between the two variables plotted in Figure 1 is “stationary.” Formally, the two variables would be cointegrated. Since the difference between the variables is the natural log of their ratio, cointegration would imply that the ratio should be stationary. Testing this ratio for the presence of a unit root (non-stationarity) using a number of accepted tests yielded consistent results: the null hypothesis of a unit root could not be accepted (results available upon request). Thus, foreign interest payments on the U.S. debt and GDP do not “wander-off” in opposite directions very long without eventually reverting back to a mean distance.

While there will be a burden placed on future generations because interest on the debt will have to be paid to foreign investors, we should certainly be able to meet these obligations as long as GDP continues to grow at least as much as interest outflow. The real concern here is sufficient demand and the sustaining of economic growth, not
whether the debt burden will “squander our children’s future” or “impoverish generations to come” (http://www.marketwatch.com/story/massive-debt-threatens-to-impoverish-our-children-2010-02-02).