Chapter 16 -- The Question of the Public Debt

Thomas Piketty, Capital in the 21st Century (Harvard University Press 2014)

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The Public Debt

- Governments finance their expenditures with taxes or debt.
- In the 19th century, UK public debt exceeded 2 years of national income!
- Today, the average public debt in rich countries is about 1 year of national income — or 90% of GDP — the highest levels in peace time — and about 30% of GDP in emerging countries.
- Europe has the highest level of private wealth in the world, but the highest level of public debt — The governments of rich countries are poor!
- Some countries get stuck in perpetual debt crises. Some countries default on debt or 'monetize' it with inflation. The United States congress is periodically deadlocked over 'debt limit' negotiations.

Reducing Public Debt

- To reduce public debt, governments could:
  - 1. cut public spending;
  - 2. raise tax revenue;
  - 3. let inflation reduce the real value of debt.
- In the past, governments have often allowed inflation to creep up above market expectations, amounting effectively to a partial default — Germany, France, and the UK have at times 'monetized' their war debts.
- Figures 3.3 shows that in just 5 years, between 1945 and 1950, UK public debt fell from 200% of GDP to 30%. There is little support today for an inflation hike — the independence of central banks and strong anti-inflation mandates reflects this aversion to monetization.
- Piketty argues that a tax on net private wealth would be just and efficient.

Reducing Public Debt

- In Europe, debt levels have been only partially financed via moderate public spending cuts and tax increases. Some countries have had large levels of debt for decades, e.g. Belgium, Italy, Greece. Some countries with historically low debt saw it rise fast after the financial crisis, e.g. Spain, France. Greece is now in a position where it cannot finance its debt without external financial assistance from other countries or the IMF.
- In the United States, republican rhetoric supports both public spending cuts and tax cuts, but in practice the Reagan and Bush administrations have implemented large tax cuts and large public spending rises, causing very large increases in public debt that subsequent administrations have sought to reduce.

Reducing Public Debt

- In most European countries, national wealth is close to 6 years of national income, most of it private wealth. The value of public assets is approximately equal to public debt — net public wealth is about zero.
- In theory, if the public buildings, schools, universities, hospitals, police stations, motorways, bridges, and other infrastructure of Europe were sold at market prices, public debt could be eliminated.
- Private wealth (net of debt) can be divided into two roughly equal halves: real estate and financial assets.
- Europe's average net asset position with the rest of the world is about zero: firms and public debt are 'owned' by European households — what the rest of the world owns of Europe is offset by what Europeans own of the rest of the world.

Reducing Public Debt with a Wealth Tax

- A flat tax of 15 percent on private wealth would yield nearly a year's worth of national income. The state could use the revenue to pay back all outstanding public debt. It would then have no interest to pay.
- Total repayment of the debt by a one-time wealth tax is equivalent to total repudiation, except for two essential differences:
  - 1. the cost is borne by individuals in proportion to their net wealth, irrespective of the amount of public debt held in the portfolio;
  - 2. the effect of the tax is predictable, unlike the effect of a debt repudiation — even partial.

Reducing Public Debt with Inflation

- Inflation can reduce debt levels.
- Since a government bond is a nominal asset, a rise in inflation reduces its real value.
- An annual inflation rate of 5\%, instead of 2\%, would reduce the real value of the public debt by more than 15 percent (as a percentage of GDP)
- This is how most war debts have been reduced in Europe.
- Between 1914 and 1950, inflation averaged 13 percent a year in France, 17 percent in Germany.
- The Fed, BoJ, and Bank of England are currently trying to raise their inflation targets — the ECB is not — if they succeed, they will be free of debt more rapidly than the Eurozone.

Reducing Public Debt with Primary Surpluses

- It could take several decades for the Eurozone countries to emerge from the debt crisis. Consider a scenario.
- Assumptions: Inflation is zero; GDP grows at 2 percent a year (an optimistic forecast); budget deficits stay below 1 percent of GDP — at current debt levels, interest payments add several points to the deficit, so this would require substantial primary surpluses. Under these assumptions, it would take 20 years to reduce the debt-to-GDP ratio by twenty points.
- If growth fell consistently below 2 percent and deficits rose consistently above 1 percent, it could take 40 years.
- Just as it takes decades to accumulate capital, it takes decades to reduce debt.