

FE431: Public Finance Course Notes

Part V: Deficits and the National Debt

“The progress of the enormous debts which at present oppress, and will in the long-run probably ruin, all the great nations of Europe, has been pretty uniform.”

“The reduction of the public debt in time of peace, has never borne any proportion to its accumulation in time of war.”

“When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by a bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment.”

“The raising of the denomination of the coin [inflation] has been the most usual expedient by which a real public bankruptcy has been disguised under the appearance of a pretended payment.”¹

- Adam Smith, *The Wealth of Nations* (Book V), 1776

“The fact that we are here today to debate raising America's debt limit is a sign of leadership failure. It is a sign that the US Government cannot pay its own bills. It is a sign that we now depend on ongoing financial assistance from foreign countries to finance our Government's reckless fiscal policies. Increasing America's debt weakens us domestically and internationally. Leadership means that, ‘the buck stops here.’ Instead, Washington is shifting the burden of bad choices today onto the backs of our children and grandchildren. America has a debt problem and a failure of leadership. Americans deserve better.”

- Senator Barack Obama, March 2006

¹ Remember that the American Revolution was fought, in part, over taxes levied by Great Britain on its colonies to help pay its public debt (incurred most recently through the French and Indian War, 1754 – 1763).

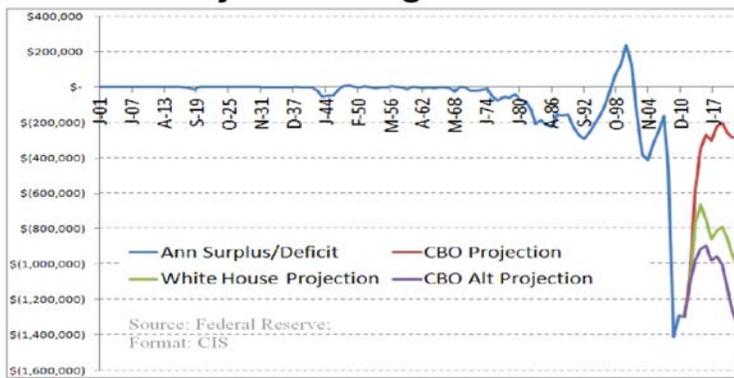
I. General concepts

- Deficit (or surplus) =

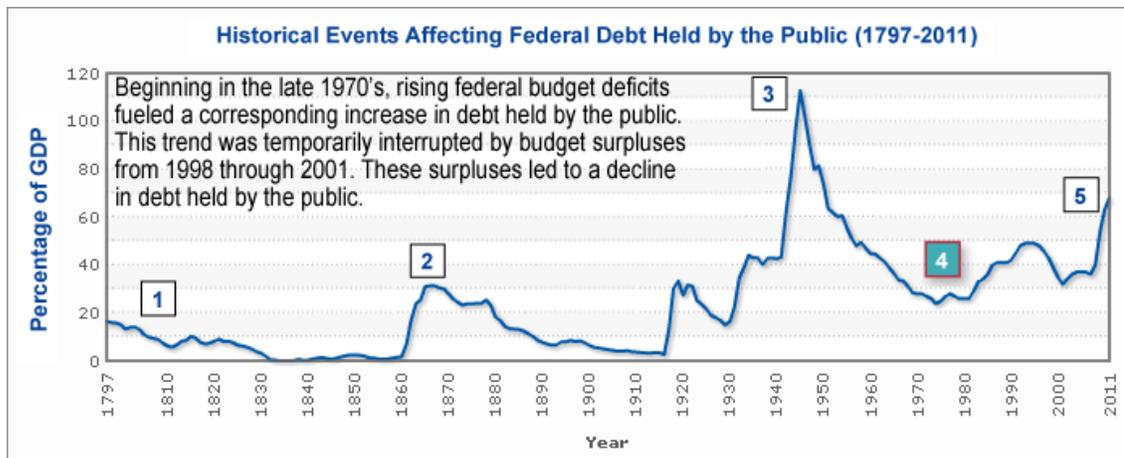
- National Debt =

- The U.S. Federal Government has run a budget surplus in only four of the last fifty years (and then ran a deficit also in those years if future unfunded liabilities incurred for Social Security and Medicare are taken into account)

Projected Budget Deficits



After a short term relief, budget deficits are expected to continue to get larger



From: <http://www.gao.gov/special.pubs/longterm/debt/budgetdebt.html>

Concluding remarks:

The four most important public finance reforms (according to Prof Swope):

1. Tax reform

- ⇒ Reduce or eliminate the corporate income tax; replace revenue with a combination of VAT taxes (e.g. 8 – 9% VAT or similar consumption tax) and carbon taxes (e.g. gradually increasing the Federal Motor Fuels Tax, which would also achieve environmental and national security goals)
- ⇒ Simplify income taxes → eliminate virtually all loopholes in personal tax system (reduce or eliminate deductibility of health benefits, home mortgage interest payments, charitable contributions, etc, which will increase revenue, potentially up to \$1 trillion); can lower all marginal rates such that the burden on the poor and middle class remains unchanged, while slightly increasing burden on the wealthy (though the top marginal rate can still be lower, e.g. 28 – 29%); result will be a flatter, more efficient federal personal income tax

2. Health care reform (the cost side)

- ⇒ Cap the growth in Medicaid and Medicare costs and make tough allocation decisions
- ⇒ Use federal incentives to encourage “Mayo Clinic” type care (which results in high quality care and lower overall costs); tax reform above will also make “Cadillac health insurance plans” less attractive (by removing their deductibility for tax purposes); individuals will face higher deductibles and out-of-pocket health care costs for routine care

3. Education reform

- ⇒ Eliminate many federal K-12 education programs (e.g. No Child Left Behind) and use cost savings to fund state-administered variable voucher programs available to all students on a need basis and which also can be used towards pre-k / early child development programs
- ⇒ Encourage states to adopt variable voucher programs in return for federal grants to help fund such programs
- ⇒ Encourage the establishment of charter schools, particularly those that follow models that have already been proven highly effective (e.g. Kipp Academy; Harlem Success Academy, etc)

4. Reduce Federal Spending (without adversely affecting basic services – social safety net, defense, infrastructure investments)

- ⇒ Adopt Canadian style methods of rewarding public managers (with salary bonuses) for proposing cost-saving policies within their bureaucracy

(see Canada’s “Deficit Reduction Action Plan” at http://www.oic-ci.gc.ca/eng/ab-ans_cor-inf-inf-cor_drap-pard.aspx)