Government Debts Are a Burden on Future Generations

Reiner Eichenberger

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The idea that government debts are a burden on future generations is not only dominant in the public and political discourse but also consistent with the academic economic perspective. According to the Barro-Ricardo equivalence theorem, the debt burden remains with the present generation only under highly restrictive assumptions which usually do not hold, most importantly, the assumption of perfect intergenerational altruism between present and future citizens. While it can be argued that extensive altruism may exist between parents and their children, many citizens have no children. Moreover, increasing migration between jurisdictions decreases intergenerational altruism

R. Eichenberger (✉)
University of Fribourg, Fribourg, Switzerland

CREMA – Center for Research in Economics, Management and the Arts, Zurich, Switzerland
e-mail: reiner.eichenberger@unifr.ch

as it shrinks the probability that the present citizens' children will live in the same jurisdictions as their parents.

However, these arguments are rendered obsolete by capitalization of government debts into property prices. As government debts have to be served or repaid, they are a constraint on future politics. The higher the present government net debts of a jurisdiction are, the higher its future taxes have to be or the fewer government services can be provided in the future. Thus, present debts reduce the future attractiveness of a jurisdiction. This induces future property prices to decrease, which is anticipated in today's markets and reflected in present property prices. Consequently, present debts are a burden not on future generations but on present property owners.

What is the extent of the capitalization of government debts? The mechanism of debt capitalization is closely related to tax capitalization. The tax burden is shifted between factors of production depending on their relative elasticities of supply and demand. Within countries as well as between small open economies, labor and capital are highly mobile across borders, i.e., their supply is highly elastic. In contrast, the supply of land is quite or even totally inelastic. Consequently, land bears the full burden of local taxes. The same applies to local debts. The more mobile capital and labor are, the more fully land and its present owners bear the full debt burden. Thus, federalism is a protector of future generations and maximizes intergenerational welfare. While it prevents the present inhabitants from exploiting future generations, it has also protected the present generation from having been exploited by bygone generations.

In order to empirically test debt capitalization, data on gross government debts as well as government assets are needed. While such data is usually not available, Switzerland represents an exception as municipalities have been providing account balances that reflect their debts and assets for decades. David Stadelmann and I have extensively tested debt capitalization in the 171 municipalities of the Canton of Zurich for which also high-quality housing price data is available. The results are striking: Municipal debts capitalize largely if not fully into property prices, and it is the present generation that carries the debt burden. However, this is only true with high mobility of capital and labor such as it exists among lower-level jurisdictions or in small open economies. If the right to issue debts is relegated to the central level of large countries or even to the international level, e.g., to the EU, each generation can live at the expense of future generations.