Debt and Taxes: Ponzi Finance, Dynamic Efficiency and Government Solvency

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Abstract

This paper addresses three related issues. First, in what sense is the government's ability to borrow limited by its capacity to tax? Second, when is Ponzi finance feasible for an infinite-lived government? Third, when does the opportunity to engage in Ponzi finance enhance the government's ability to influence private resource allocation? We argue that convincing answers to all three questions require a careful specification of the government's "capacity to tax" and to distinguish between weak and strong Ponzi finance. We show that a weak Ponzi scheme is feasible in an infinite-lived overlapping generations economy even if the competitive equilibrium is dynamically efficient or Pareto efficient, as long as the set of lump-sum tax and transfer instruments available to the government is unrestricted. Strong Ponzi finance is only feasible if the long-run (after-tax) rate of interest is below the long-run natural rate of growth. A primary purpose of the paper is to show that the conventional solvency criterion is not generated by private sector rationality in the overlapping generations model alone, in contrast with the infinite-lived representative agent model. Rather, restrictions must be imposed on the government's capacity to tax using lump-sum instruments; strong Ponzi finance imposes such restrictions. The paper further studies when Ponzi finance is essential and inessential in the sense that it enhances the set of allocations that can be supported as competitive equilibria under alternative fiscal policies.

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