References


Comment

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In “Financial Strategies for Nation Building,” Professor Zhiwu Chen offers us two interesting observations and one brave thesis. The first observation

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is that no government lasted for more than three hundred years in imperial China. What can be done to prevent such a cycle of regime change from happening again in modern day China? This is the question that Chen sets out to answer in the chapter. And the answer, according to Professor Chen, is public debt. To justify the answer, Chen offers his second observation: governments in imperial China resorted to either taxes or inflation, but not public debt, to finance government spending. Chen argues that, when a government faces a large negative fiscal shock, using tax or inflation to finance “were politically and socially dangerous,” whereas using debt financing would have helped “spread the temporary high burden over a period of thirty to eighty years.”

To contrast with the experience of imperial China, Chen notes that, since 1982, China has a growing national debt on the one hand and an increasingly strong economy on the other. Borrowing from Macdonald (2003), Chen notes further that countries deep in debt back in 1600 tend to be developed economies today. Chen asserts that making use of public debt can “reduce the pressure for the national treasury to save so the country can invest more,” and can allow the government to “convert future fiscal revenues into capital of today.” Thus, the thesis from Professor Chen is that public debt helps the nation grow strong.

Chen’s thesis offers a refreshing perspective to examine the aforementioned two seemingly unrelated phenomena. It was a pleasure and an inspiration for me to read his article and to contemplate the intriguing observations Professor Chen has brought forward.

Chen points out three advantages of debt over tax in meeting government spending: spreading the tax burden over time, capitalizing on future tax revenues, and reducing the precautionary need for saving for the government. According to Chen, the first one is crucial for a regime to survive a large spending shock; the latter two pave the way for the nation to succeed. Given these great advantages of debt over tax, there is a natural question of why generations after generations of governments in imperial China failed to recognize these advantages, but resorted to debt that ultimately led to their own downfall. While Professor Chen does not elaborate much on this question, two explanations are possible. The first possible explanation is that debt may not enjoy as a great advantage as described. After all, debt postpones tax, and there may be little difference between the two per Ricardian equivalence. Of course, many factors pertinent to imperial China may render the equivalence invalid. Professor Chen can make his thesis more convincing by pinpointing some of these factors.

The second possible explanation is that governments in imperial China did not rely on public debt because they were not able to. One factor Professor Chen may want to consider is the possibility of government default on public debt. If there exists a dynastic cycle, as Professor Chen noted in the case of imperial China, then private agents may not even want to lend money to the regime when a regime is coming to an end. If we add the default
factor to Chen’s thesis, multiple equilibria become possible. Private agents either lend to the government and, by saving the day, the debt is eventually repaid, or do not lend to the government, in which case the government will collapse, not able to repay any debt should it have borrowed any. In other words, the presence of the dynastic cycle may have prevented public debt from being adopted.

In this case of equilibrium multiplicity, it is natural to further ask which equilibrium is more likely to emerge in the context of imperial China. I think Professor Chen can enrich his thesis by discussing the existing literature related to the dynastic cycle in imperial China, which has attributed the cycle to factors other than the absence of public debt.

Of course, the discussion earlier assumes that the next regime will not recognize the public debt raised by the previous one. I suppose that this is indeed the case for imperial China. However, this is not true for public debt in a modern society. Why there is such a difference is another interesting issue to be addressed to supplement Professor Chen’s thesis.

Leaving aside how spending should be financed, Professor Chen suggests that one possible strategy is to “spend as much as possible at the present in order to develop the economy and increase future wealth generating potential.” I believe Professor Chen can make his statement more precise if he could elaborate on why, in his view, government spending is more preferable to private spending. These issues are in fact related to his reading of China’s economic success during the last three decades, which he attributes to public debt raised by the Chinese government, whereas most students of China’s economy would probably have attributed it to the withdrawal of the government’s role in the economy.

Finally, I find the chapter to be more relevant for the survival of a dynastic regime than for the building of a nation. Although the two issues may be related, they are not the same. After all, for an extended period of human history, China remained a leading civilization and the largest economy in the world, with the dynastic cycle but without relying upon any public debt.

Reference