TOPIC IV: FISCAL POLICY

ECON1401, UNSW

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Roadmap

1. The Problem of Inference in Macroeconomics
   - Dr. Bregman at Davos
2. Death and resurgence
3. Are taxes moral?
4. Fiscal Policy as redistribution
5. Fiscal Policy as macroeconomic stabiliser
6. Keynesians .vs Monetarists

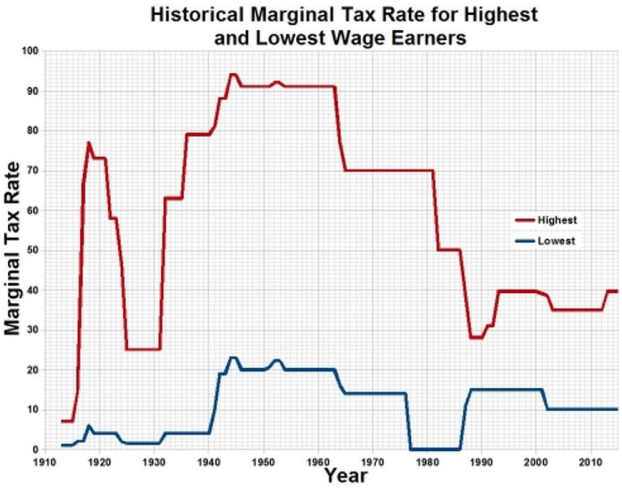
History, Inference and Bold Statements

- What is the best optimal tax regime? A very difficult question
- From a micro-theoretical perspective, tax codes are a conglomerate of incentives with complex interactions
- from a moral perspective, how much redistribution is just?
- from a macro perspective, when are they stimulative?

$$\Rightarrow \textbf{Complex theory} + \textbf{Difficult empirics}$$

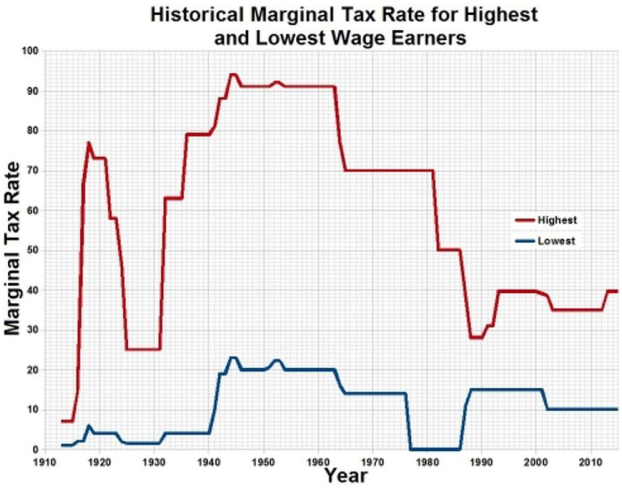
History, Inference and Bold Statements

- The classic problem: you cannot re-run history, changing one element *ceteris paribus*
- In **this viral video**, Dr. Rutger argues that US history teaches us that things were better when in the 50ies *top marginal taxes* were at 90%
- **Article source (link)**



History, Inference and Bold Statements

- 1917: The US enters WWI
- 1929: Market crash, Roosevelt
- 1932: New Deal
- 1945: Peak US military spending



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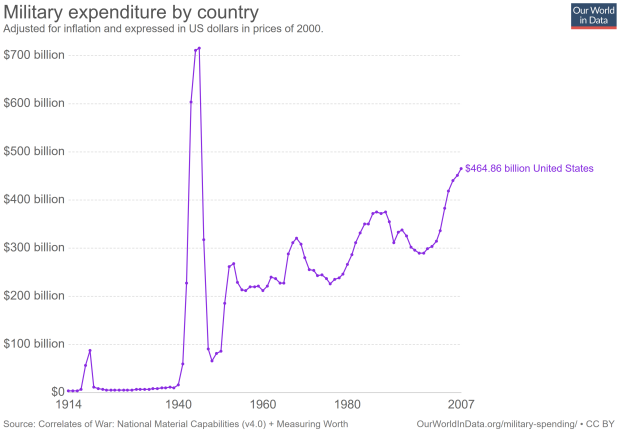
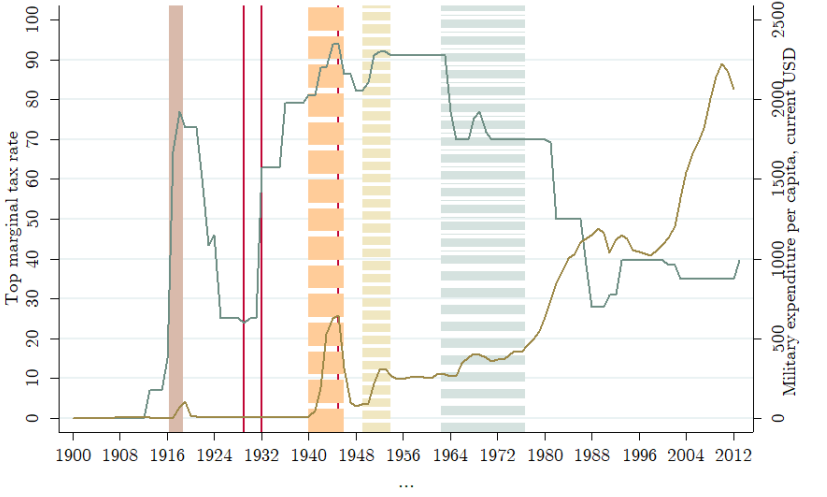
- **For more read this (link)**




Top marginal tax rate
0
10
20
30
40
50
60
70
80
90
100
Military expenditure per capita, current USD
0
500
1000
1500
2000
2500
1900
1908
1916
1924
1932
1940
1948
1956
1964
1972
1980
1988
1996
2004
2012
...
ww1
ww2
Top marignal income tax rate (%)
korea
viet
Military expenditure per capita, current USD

Causal Statements

- It is very difficult to empirically investigate the effect of fiscal policy
- Indeed, there a number of issues in the way of causal claims:
  a. Case-studies provide rich qualitative data, but it's usually possible to find plausible reasons why the effect is/isn't of the expected sign
  b. Same applies to single-country longitudinal analysis
  c. Analysis based on cross-country longitudinal data can in principle estimate the causal effect, however
     - "fiscal policy" is a very large set of policies
     - each detail of each policy alters the incentive mechanism at the micro level in often unexpected ways

$\Rightarrow$ Claims about the effect of fiscal policy often rely on strong assumptions about the structure of the economy

The Taxonomy of Taxes

Several criteria to categorise taxes, depending on the criterion:

I. Direct ≡ a tax imposed by a government to an entity (firm or individual)
   - e.g. income tax, taxes on assets
   - progressive: often exempts the poor, targets the richer individuals

II. Indirect ≡ a tax on goods and services paid to an intermediary in the supply chain, which then transfers it to the government
   - e.g sales tax, import duties, value added tax (VAT)
   - regressive → the purchased goods represent a larger share of income for the poor

⇒ both redistribute

From less to more progressive:

1. Poll tax = every individual pays the same fixed amount.
   - Was introduced at the end 14th century in England and lead to The Peasants' Revolt in 1381. Thatcher implemented it in 1989, causing the Poll Tax Riots (1990). It was abrogated in 1992.
2. Sales tax → Europe 17-20%, US 5-8%, AUS 10%
3. Flat income tax = each individual is taxed the same fraction of her income
4. Progressive income tax = higher incomes are taxed at a higher marginal rate
5. Flat wealth tax = a constant tax rate on wealth
   - inequalities in income tend to lead to even larger inequalities in wealth
6. Progressive wealth tax = a tax rate that grows as the wealth grows
   - France and Switzerland implement a version of it

Source: Freakonomics blog **(link)**

Fiscal Policy Reloaded

- We have gone a long way since the non-interventionists (especially in fiscal policy matters) Monetarists and New Classicals
- The stern Austrians are still around the corner though
- Fiscal policy, in the good and bad, is again at the centre of the stage
- As often in Economics, the change has been brought by a crisis

Keynesian Fiscal Multipliers

- Idea: for every 1\$ of G_t, there is a $>$ 1\$ increase in real GDP
- Bridge-building example: +1 billion G_t (hence GDP too) $\Rightarrow$ + profits, wages $\Rightarrow$ + real D_t and C_t $\Rightarrow$ + GDP & + profits for producers of newly demanded goods $\Rightarrow$ + GDP, etc.
- Ripple effect
- Size of multiplier depends on MPC and PMI

  $\Rightarrow$ story of hole-digging *and* of productive investment
- Expansionary: + G_t, - T_t, + transfers (opposite is contractionary)

The Laffer Curve

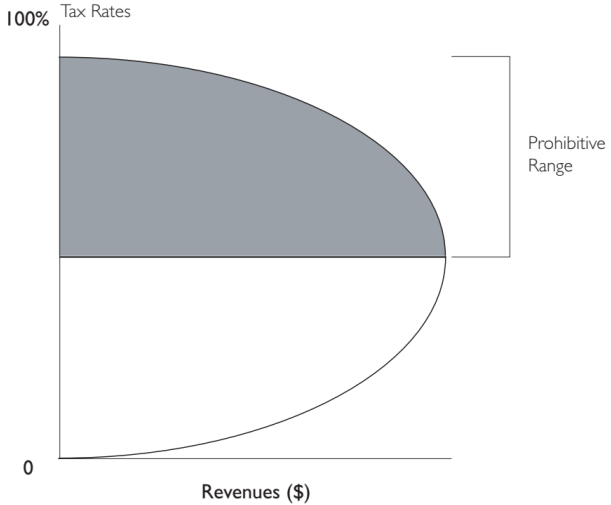
Our story starts with 4 friends at a restaurant...

D. Cheney (Rumsfeld's deputy), J. Wanniski (WSJ), D. Rumsfeld (Pres. Ford's Chief of Staff), A. Laffer (UChi), talking about Ford's proposed tax increases

The Laffer Curve

- Source (very ideological) **(link)**
- Not a new idea
- Ibn Khaldun (14th century)
- Keynes: "taxation may be so high as to defeat its object, [...] [like] a manufacturer who, running at a loss, decides to raise his price"
- Arithmetic effect
- Economic effect (output, employment, hence tax base)
- People care about post-tax income
- at 0% and 100% no revenues and 2 points for any other level of revenues

The Laffer Curve



The Laffer Curve

A few notes:

- It makes some sense, but probably not in that shape
- National preferences and trust in government surely impact it (also modelled in Antoci et al., 2014)
- Difficult to prove: models are tautologic, data is probably insufficient for estimation
- Indeed, the current literature has evolved only in the direction of more sophisticated models (plus some experimental)
- Anecdote: self-employed professionals in Italy

The Laffer Curve

Problems, according to Mirowski (1981):

1. Size of elasticities
2. Problems of empiricism
3. Omitted variables
4. Size of the underground economy

"Diamond" bullet points [⋄] taken from Fullerton (2008)

The Laffer Curve: Size of Elasticities

- The evidence then was that the men's elasticity of income & subs wrt marg tax rates was about zero
- Positive for married women and teenagers
- Supply-siders discredit empirical work but then remake their own estimates
  - Heterogeneity implies *the* elasticity does not exist
  - Tax systems are too complex for people to know the effective tax rate and it's progressive too
  - Avg rate affects revenue, marg rate affects behaviour $\rightarrow$ Laffer effect more likely from cut at top of marg rate
  - If you don't care, the most recent estimates for the peak $t^\star$ is 71%

The Laffer Curve: Empiricism

- The curve is undetermined both qualitative and quantitative

QT Laffer says the US is in the *prohibitive range* but cannot measure the peak of the curve

QL The 100%-0-revenues point might not exist (in communist regimes people do work) $\Rightarrow$ no *prohibitive range*

- They hide behind story-telling of past cuts $\rightarrow$ but cuts are per se expansionary already

  - The existence of point-100% depends on how much revenue is spent on public goods vs transfers

The Laffer Curve: Omitted Variables

- There is no single rate: not for an individual, not for the economy
- To test for the existence of such curve you need a very good model of the economy
- In the current literature I found models able to produce the curve, used as evidence in favour

The Laffer Curve: Underground Economy

- No one knows how big it is
- Unlikely that tax evasors would change their minds in mass
- You would need highly elastic, high evasion $\rightarrow$ both unmeasurable
- Tax evasion is only a minor point though

Austerity

- Blyth (Brown University) on this (video)

- Alesina at Ecofin meeting (2010) (**link**): "In the aftermath of the Great Recession, many OECD countries now need to reduce large public sector deficits and debts."
  - "anticyclical fiscal policy based upon spending increases in recessions and tax increases to correct the deficits during expansions is likely to be counterproductive"

Austerity-bis: Alesina, Favero & Giavazzi (2018)

- "Whether or not fiscal consolidations [...] are more costly when started during an economic downturn is a difficult point to discern"
  - "[...] fiscal consolidation removes uncertainty and stimulates demand by making consumers and especially investors more optimistic about the future"
  - Post-crisis FP confirms that tax-based contractions are more recessionary than expenditure-based contractions

> "Imagine a situation, for instance as described in Alesina and Drazen (1991), in which an economy is on an unsustainable path with an exploding public debt. Sooner or later a fscal stabilization has to occur. The longer one waits, the higher the taxes that will need to be raised (or spending to be cut) in the future. When the stabilization occurs it removes the uncertainty about further delays which would have increased even more the costs of the stabilization. Blanchard (1990) provides a simple model which illustrates this point."

An Australian Expansionary Fiscal Contraction Tale

- Alesina & Ardagna (1998): they analyse expansionary austerity case-by-case
- Quiggins (University of Queensland) responds **(link)**⇒ AUS quietly dropped in later pubs

> [...] direction of causality is reversed. The strong expansion that began in 1983 drove much of the fiscal consolidation directly, and created the political-economic environment in which tight fiscal discipline was feasible without economic contraction, and politically salable. The severe recession that began just after the triumphant return to budget surplus wiped out all of the fiscal consolidation of the previous decade – balance wasn't restored until years into the expansion with a consolidation that produced an increase (admittedly temporary) in unemployment, as Keynesian theory would predict.

Fiscal but How?

- Fatás: counter-cyclical fiscal policy **(VoxEu.org link)**
- De Long: Expansionary right before the crisis **(link)**

  $\rightarrow$ should delay the recession and raise neutral interest rate hence creating more monetary space for the crisis
- Thoma: create an Fed-style independent (countercyclical) fiscal authority, coordinated with the Fed **(thefiscaltimes.com link)**
- Blinder (1997): same Fed-style institution, setting the rate of a VAT **(link)**
- Helicopter money
- Modern Monetary Theory

Wren-Lewis: Monetary vs Fiscal Policy Instruments

1. Instr quick to affect demand? Biiiig question, not critical to the mainstream preference for MP
2. Instr quickly changed? MP: yes, FP: no
3. Limits to the change? MP: ZLB, FP: no
4. Is the effect reliable and consistent? MP: yes, FP: G_t yes while T_t no
5. Instr in good, competent hands? UK-type CB: independence but w govt mandate hence credible. This is different for FP, which is politically hard to implement due to popularity asymmetry of expansion vs contraction (difficult to delegate)
6. Side effects of instr? Probably more for FP, due to distortions and complex micro-effects

   $\Rightarrow$ Monetary Policy should be the main instrument? it surely helps reducing fiscal stabilisation

The Morality of Taxes

Richard Baron **(link)** reviews the main philosophical issues on taxation from the perspective of *Utilitarianism*, U, *Deontology*, D, *Virtue Ethics*, V

* Total Amount of Tax
  - U) redistribution increases consumption ⇒ good
  - U) too much redistribution reduces incentives to gain ⇒ aggregate output levels reduced ⇒ bad
  - D) duty to respect property rights ⇒ no taxes? taxes conditional on use (difficult to enforce)?
  - V) moderate taxes (not high) encourage virtues → use of talents, charity, independence

The Morality of Taxes

N) Nozick (1974): taxation as coercion
- a resource distribution is just if the initial acquisition and the later exchanges through which it emerged were just
- if that is the case, a state intervention is an abuse of the majority over a minority

M) Murphy & Nagel (2002): the state builds the framework on which wealth is made and protected
- without the state, wealth would be much less and growth zero

The Objectives of Taxation

* Provision of public services (law & order, healthcare, education,...)
  - U) good: more production, more consumption and desire-satisfaction
  - V) good: more use of talents and flourishing
  - D) not specified (human rights?)
* Aid to the poor
  - U) good: as above
  - V) good: as above
  - D) duty of helping the poor
* Promotion of equality of outcomes
  - U) ambiguous: there's a trade-off with other objectives → good in that it promotes a more stable and peaceful society
  - R) Rawls (1971): greatest benefit to most disadvantages, equal society supported by veil of ignorance
    - the poor might benefit more by more unequal society though (trickle down?)
  - D) duty of helping the poor

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