Elements for the political economy of public debt and tax cuts

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Introduction

• The traditional Keynesian analysis of public debt is incomplete
• Post-Keynesians: present public debt as a “good” thing (multiplier effect)
• A challenging evidence:
  • public debts have increased without significant improvements of growth and employment.
• mainstream economics has always
  – claimed that public debt is an “evil”
  – and doubted about the multiplier effect.
• Implication of public debt on reproduction and organisation of both the state and the financial system

• = essential elements related to the reproduction of the social order

⇒ Ideology

• What is ideology?
Definition of ideology

- set of ideas which dominate society
- ideas produced by and on behalf of dominant classes (which possess the means of production and diffusion of ideas across society and are well represented inside the state apparatus)
- their function is to justify and legitimate the existing social order (they present themselves as unquestionable and non partisan)
- most of the time, reality is reversed or at least misrepresented by those ideas => ideology conceals reality, not least exploitation relations.
Basic mechanisms about the evolution of debt/GDP ratio

• Business cycle

• Crisis

• Current situation

• what about tax cuts?
Two statements

1. “Public debt is a burden which is transferred from one generation to another; future generations will have to pay for previous ones.”

2. “The rise in public debt has been caused by an excess of public expenditure.”
Statement 1: intergenerational burden

- Statement 1 is incorrect.
- Transfers through (public) debt occur inside a single generation between those agents who hold public bonds and the others.
- Statement 1 is used to conceal the class content favourable to dominant stratums of public debt by a “generational” argument.
Statement 2: is public spending responsible for the rise in debt/GDP ratios?

• Theoretical level

• Empirical level

• What about tax receipts?
The class content of tax cuts 1/2

• targeted towards high income households
• “Starve the beast” strategy
• increase in private demand for assets (fuelling financialisation), notably public bonds
• Public finance: tax cuts create a lack of tax receipts
  ⇒ increase in supply of public bonds
• The government pays more interest to those who precisely have less tax duties.
  ⇒ Public debt = manifestation of the antisocial redistribution induced by targeted tax reductions.
• Is the multiplier likely to compensate for the increase in the burden of the debt on low income households?
The class content of tax cuts 2/2

• In the euro zone (because of the “stability and growth pact”), the multiplier has been very small (and the debt ratios have grown regularly)
  ⇒ the increased burden of the debt borne by low-income households has not been offset by a better macro situation
• ideology (statements 1 and 2) masks this class content of public debt and now intends to reduce public spending towards low and middle income households (education, health, welfare, pensions…).
• If public spending is reduced
  ⇒ low and middle income households would hence pay twice for high income households
    ⇒ one for the increase of the public debt
    ⇒ one for its reduction!
• But, at the macro level, the reverse redistribution through public debt may not end because the reduction in public spending is likely to fuel deflation, i.e. public debt to GDP will probably not decrease.
Tax cuts: “double dividend” for some and “double penalty” for the others

- High income households = « double dividend »
- Public administrations = « double penalty »
- Low and middle income households = « double penalty »
A simple model based on the main accounting equations of Godley & Lavoie (JPKE 2007) and Martin (JPKE 2008)

- $Y = C + G + I + TB$
- Public debt $B = (1 + rG)B_{-1} + G - T$
- $T$: tax in proportion to households income
- Two types of households
  - Type 1 households (low income) spend all their disposable income. They only earn wages, taxed at the rate $\tau_1$.
  - Type 2 households (high income) spend a share $(1-s)$ of their disposable income and a share $(\gamma)$ of their saving stock $(V)$. Their income (high wages, dividend and interest) are taxed at the rate $\tau_2 = \tau_1 + \tau'$. 
Hypotheses

- $V/B=\mu$ ; $I=\kappa Y$ ; $TB=\delta Y$
- Production allocation
  - Self-financing of a share of investment: $\varphi I$
  - Share of type 1 household’s income in the GDP: $\alpha(Y-\varphi I)$
  - Share of type 2 household’s incomes in the GDP: $(1-\alpha)(Y-\varphi I)$
3 cases have been examined

1. automatic stabilisers are efficient: public spending is supposed to adjust according to private spending so as to maintain full employment

2. public spending is autonomous but insufficient to maintain full employment

3. “Maastricht” (“growth and stability pact” -GSP) or pro-cyclical deficit case: public spending adjusts to private spending so as to ensure a target value of the public deficit to GDP ratio.
Main results

1. The debt/GDP ratio always stabilises on the long run for realistic values of the parameters.
2. Tax cuts (or increases) conceded (imposed) to high income households give rise to an increase (fall) in the long term debt/GDP ratio whereas targeted tax cuts (or increases) on low income households have no effect whatsoever on the ratio.
3. The debt/GDP ratio is an increasing function of the national income going to saving households;
   • In other words, all things being unchanged, an increasing debt/GDP ratio can be interpreted as an expression of the rise in income inequality in the society.
   • As inequalities have a macroeconomic impact through savings behaviour, a predictable corollary of the previous result is that higher saving propensity leads to higher debt/GDP ratio, i.e. private savings “calls for” public debt.
Maastricht case results

1. short run:
   - a lower tax rate on high incomes reduces GDP.
   - a rise in the deficit/GDP target ratio gives leeway to the government to increase its outlays without changing tax rates which has a positive impact on GDP.

2. Long run:
   - if the target deficit ratio is too low then the growth rate of the activity can be lower than the population growth.
   - an increase in the target deficit ratio reduces the debt ratio