Higher taxes – a solution to the crisis?

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This question, which may seem provocative, is worth asking provided that consideration is given both to the full dimensions of the crisis, and not just its financial aspects, as well as to the assumptions needed to make this a credible scenario. In the perspective discussed here, if tax hikes are to play a role, it would not be as part of a fiscal adjustment intended to restore public accounts worsened by the crisis, but rather with the aim of maintaining or restoring a level of productive spending that was altered by increasing inequality. Furthermore, everything would depend on the nature of both the taxation and the government spending.

Everyone agrees today that rising inequality, particularly in the United States, has had an influence on the course of events. The indebtedness of the least affluent households merely delayed a fall in aggregate demand. The realization that these households were insolvent is what triggered the crisis. Furthermore, there is no solution in the medium or long term without deleveraging both households and business. The role of the public authorities is to assist this. But they can do this only by taking decisions that wind up increasing the public debt. Public debt is thus substituted for private debt. The debt-financed public deficit also needs to be stretched out until consumers and business have been able to get back to a balanced financial position enabling them to raise their level of consumption and investment. This scenario is, however, running up against the potential insolvency of the states, a situation that is particularly aggravated in the euro zone. It does not actually explain what are the sources for a recovery in consumption and investment due to a failure to relate this to the implications of rising inequality in regards to the distribution of demand for productive and non-productive activities.

Recognizing the weight of inequality means, of course, recognizing that there is a problem with demand, but it also requires recognizing the heterogeneity of consumers and the non-homothetic nature of individual preferences. The rise in inequality is most of all changing the structure of demand. Some would say this is at the expense of goods consumed primarily by the mass of workers, to the benefit of luxury goods, while others would say at the expense of productive assets and to the benefit of existing financial and real estate assets.

The following mechanism might be at work. The richest households have excess savings that they devote, on the one hand, to the purchase of luxury goods and assets on the financial and real estate markets, and, on the other hand, to loans to less affluent households channelled through financial intermediaries. The rise in inequality thus has two combined effects: pushing up the price of assets purchased by the more affluent, and raising the level of indebtedness of the less affluent. The first effect supports the second by allowing the loans granted to rely on the increasing value of the assets pledged (the “collateral”).

Based on the assumption that public spending is a productive expenditure – it fuels demand for goods and services from the productive sector – an increase in public debt would support aggregate demand and stem the recession. However, in the medium term, interest charges could make it difficult to sustain the public debt with – and this is key – a need to reduce public spending before there is a significant recovery in private spending. The substitution of public debt for private debt shifts the problem, without solving it.

One possible alternative might be to tax the income of the wealthiest households. Still on the assumption that public spending is directed at the productive sector, this kind of taxation would ensure a redistribution of income, with as a corollary a reconfiguration of the structure of demand in favour of productive activities. Another assumption would also be necessary: that the additional taxes are actually paid by households that use a significant portion of their savings for the purchase of non-productive assets. In this situation, the objective would not be to raise taxes to absorb the public deficit in the hope that an economic recovery would make it possible to reduce them later, but rather to make better use of taxation as a tool for redistribution. While the tax burden would indeed increase, the point is to tax incomes that, in large part, consist of rents that go to unproductive consumption.

The hypotheses used here are somewhat uncertain due to the nature of public expenditure and revenue. Some public expenditure is unproductive, and it is difficult to distinguish what is productive from what isn't. The tax increases would affect different categories of taxpayers without actually discriminating between them according to the structure of their spending.

Furthermore, our purpose here is not to set out a credible solution that can be applied immediately. The point is to highlight the illusory nature of all-embracing solutions, whether this is a matter of generalized austerity, involving tax increases that wind up weighing down household and business spending, or the prolonged maintenance of public debt, which merely replaces private debt without affecting the structure of demand. So, following this analytical digression, this points to the conclusion that the effective implementation of a redistribution mechanism that could lead to an increase in potential output requires a reform of the state that affects both the orientation of public spending and the structure of taxation, all of which requires time and foresight, not to speak of political courage.

… See Amendola, M., J.-L. Gaffard and F. Patriarca (2013), “Inequality, debt and taxation: the perverse relation between the productive and the non-productive assets of the economy”, *OFCE Working Paper No. 2013-21*.