More on Debt and Taxes

Objections to Ricardian Equivalence

• People don’t understand deficits.
• We have passed the debt to our children.
• This means we never need to tax.
• Incentive Effects.

People Don’t Understand Deficits

• People do not understand the equivalence between taxes now and taxes in the future.

Lincoln’s Law

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• You can’t fool all the people all of the time.
• Lincoln’s Law implies that people will not be systematically fooled.

Economists refer to this as Rational Expectations.

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Rational Expectations

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Suppose the policy choice is between taxing John and Sally each $50 now or $50 in the future.

Some years both John and Sally will over-estimate their future tax liabilities; other years they will underestimate them.

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While John may blithely underestimate his future taxes, Sally may panic and overestimate hers. Rational expectations implies their errors will cancel out.

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The General Theorem

A general theorem: models built on the assumption that people are stupid just don’t work.
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Just What Does This Mean

- We reduce investment to finance the deficit, and hence reduce the capital available for future generations.
- For this to happen, there must be a differential impact on the demand for loans.

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John’s Taxes

- The government decides to spend $100, and tax John to pay for it. $\Delta z = -$100 so $\Delta c = -$10 (say). Ergo, John’s demand for loans increases by $90.

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  - John gets hit for the taxes to pay interest and principal.
  - **No big deal. The present value of John’s Tax Liabilities is $100, so taxing and borrowing are equivalent.**
John’s Taxes

• Instead of taxing John – aged 40 - $100, and reducing his wealth by $100, the government decides to borrow the money.

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• The government borrows $100 in a consol, a bond that will pay $5 a year in perpetuity.

• John gets hit for the taxes to pay the interest.

The government’s demand for loans is $100
but John, reducing consumption by $10 supplies another $10 of loans. The net demand for loans goes up by $90.

The present value of John’s tax liabilities will equal to $100.

If John expected to live forever, no big deal.
The PV of the tax liabilities will equal to $100.

If John expects his life expectancy is 40 years, and the PV of $5 a year for 40 years is $85.

Score another win for Ricardian Equivalence equal to $100.

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• But how?
• Instead of taxing John

John's Life Expectancy is 40 years, and the PV of $5 a year for 40 years is $85.

If John were hit with a $100 tax, $\Delta z = -$100 and $\Delta c = -$10. Here, $\Delta z = -$85 and $\Delta c = -$8.50. The net demand for loans goes up by $91.50 interest. After he dies, his kids get the bill.

Debt and Taxes

• If consumers are immortal consumers, then borrowing and taxing are equivalent.
• If not, then borrowing and taxing are not equivalent, but consumers do discount taxes during their lifetime.

In short, the bequest motive can save the day for Ricardian Equivalence.

Don't put this in the loss column just yet for Ricardian Equivalence.

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But is there a bequest motive? And is it the same for all consumers like immortal consumers?

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As a practical matter, many economic models assume immortal consumers and hence Ricardian Equivalence.

If there is a difference between borrowing and taxing – which there may well be – it is small.