Fiscal Fallacies*

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"Mainstream" economics does not appear to understand the functioning of the bourgeois economic order; and nowhere is this more evident than in matters relating to fiscal policy. It holds to this day that a fiscal deficit "crowds" out private investment by reducing private borrowing. This presupposes that there is a fixed pool of savings in the economy in any period, of which if the government takes more (for meeting a fiscal deficit) then a correspondingly lesser amount is left for the private sector leading to a reduction in private investment.

The fallacy in this argument is that there is no fixed pool of savings; savings increase as the total Gross Domestic Product increases, and since the government expenditure that is financed by borrowing (a fiscal deficit) increases aggregate demand and hence output and employment (a capitalist economy is demand-constrained except in times of war), the savings pool also increases with the fiscal deficit. In fact, assuming for simplicity a closed economy with no foreign transactions, the savings pool keeps increasing until the excess of savings over investment in private hands exactly equals the fiscal deficit. A fiscal deficit in other words, instead of taking resources from a fixed savings pool, "finances itself", by enlarging the pool by an amount exactly equal to itself.

A similar fallacy is repeated by "mainstream" economics on the issue of taxing capitalists to finance government expenditure. If the government spends Rs.100 and raises the resources for it by taxing capitalists' profits to the extent of Rs. 100, then "mainstream" economics argues that capitalists' profits go down by Rs.100. "Mainstream" economics in other words sees the entire process as follows: the government takes Rs.100 from profits, reducing post-tax profits by this amount, and then uses this sum for its own expenditure.

This however is completely wrong. If we continue assuming for simplicity that we are dealing with a closed economy with no foreign transactions (alternatively we could assume both here and in the case discussed earlier that the current account deficit on the balance of payments does not change at all), and that the working people consume what they earn, then this entire process outlined above will leave post-tax profits completely unchanged compared to earlier, instead of reducing post-tax profits as "mainstream" economics believes.

The reason is simple. The government expenditure of Rs.100 raises aggregate demand and hence output and employment. But matters do not end there; this increase in output raises wages and profits in the sectors whose output increases, which in turn raises demand (for consumer goods) further, and hence output and employment further. Through such successive rounds of output increase, there will be an overall increase in pre-tax profits as well; and these rounds will continue until pre-tax profits have increased by an amount such that Rs.100 of tax on profits will leave post-tax profits exactly unchanged compared to earlier. Hence the tax on profits, instead of reducing profits, leaves post-tax profits completely unchanged.

In a capitalist economy where there are just two categories of income, wages and profits, and where all wages are consumed the following formula must hold:

Profits after tax = Capitalists consumption +Capitalists' investment + Fiscal deficit - Current deficit on b.o.p.   (A)

If there other categories of income like those of the self-employed (as indeed there are in a country like India), the formula has to be modified; but its general conclusions remain valid. By assuming a closed economy (or zero current balance) we ignore the last term. Capitalists' consumption and investment in any given period can be considered a given sum, dependent on decisions taken earlier. Hence if the government balances its budget, i.e. if the fiscal deficit is zero, then no matter how much the government spends (it raises in this case an equivalent amount of taxes), the profits after tax remain unchanged. They remain unchanged no matter on whom the taxes are levied. If they are levied on workers, then post-tax profits remain unchanged, but there is no increase in aggregate demand and output (since the government now buys an amount equal to what the workers relinquish); and if taxes are levied on the capitalists, even then the post-tax profits remain unchanged, but there is a net increase in aggregate demand and output.

If post-tax profits remain unchanged even when larger government expenditure is financed by taxing profits, then it follows that even if investment decisions are governed by post-tax profitability, there should be no adverse effects on the investment decisions of the capitalists. And if their investment decisions are governed not by the post-tax profits but by the degree of capacity utilization in the economy, then since government expenditure financed by a tax on profits increases aggregate demand and hence output, and hence capacity utilization on already installed equipment, capitalists' investment should increase compared to what it otherwise would have been.

Likewise, if government expenditure is financed not by taxing profits but by taxing wealth, post-tax profits would still remain unchanged, as is clear from (A) above (since the fiscal deficit remains unchanged, with government expenditure being balanced by equivalent taxes). But a wealth tax is levied on wealth no matter in what form it is held. It follows that if wealth is held in the form of money, earning next to nothing, the tax paid would be no different from when the wealth is held in the form of capital stock earning a rate of profit. Under these conditions, capitalists would obviously prefer to hold their wealth in the form of capital stock rather than money, which, other things remaining the same, would have the effect of increasing investment compared to what it otherwise would have been. Neither a wealth tax nor a tax on profits therefore, if the proceeds are spent by the government, can possibly be objected to by the capitalists on strictly economic grounds.

These are elementary propositions which had been elucidated by the well-known Polish Marxist economist Michal Kalecki decades ago. They still do not appear to have been understood by "mainstream" economics. This is borne out by the claim, often advanced, that taxes on capitalists will discourage private investment. Indeed this claim has been recently advanced by The Financial Times of London (which represents the views of British finance capital) apropos the manifesto of the British Labour Party that is about to fight a parliamentary election under the leadership of Jeremy Corbyn. According to The Financial Times "the assault on business is an attack on wealth creation".

Such views were held by finance capital when John Maynard Keynes who had advocated State intervention in “demand management” was explicating his ideas in the 1930s; finance capital had in fact opposed Keynes’s suggestions even though he had been concerned with rescuing capitalism from the threat of socialism. Keynes had believed however that the opposition of finance to his ideas sprang from ignorance; and that once the import of his ideas was understood this opposition would disappear. But it clearly has not, which suggests that there is something else underlying this opposition than mere lack of understanding.

Michal Kalecki again had hit the nail on the head when he had written in an article in 1943 that capitalists’ opposition to State intervention arose not because of any valid economic reasons but because of their “class instinct”. This “class instinct” told them that State intervention for stimulating aggregate demand and hence employment via larger State spending, rather than by giving concessions to capitalists to induce them to invest more (as the Modi government has been doing), would undermine the social legitimacy of capitalism.

It is not any sound economic reasoning but this class instinct which drives capitalists to oppose programmes such as Jeremy Corbyn is putting forward. If private investment dries up in the event of Corbyn becoming the next Brtish Prime Minister, the reason would have been not economics, but this “class instinct” that would have prompted opposition from them in the form of an “investment strike”.

True, Britain being an open economy, Corbyn’s plans would have repercussions on the British balance of payments which need to be examined; but the criticism of The Financial Times is based on arguments that invoke not the balance of payments but the dangers to “wealth creation”. These dangers arise because of capitalists’ wilful opposition rather than anything in the economics of the agenda itself.

When there is such wilful opposition by the capitalists, Corbyn will have to rely on the public sector to keep up investment. His plan, confined to building “welfare capitalism” to start with, will then perforce have to go beyond it owing to this opposition of the capitalists.

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