A Fiscal Theory of Populism and the Paradox of Endogenous Nationalism

Massimo Morelli

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Introduction

- (1) Labor falling share plus (2) dependent labor already taxed quite heavily plus (3) tax competition that causes tax revenue to be mostly on labor income plus (4) increasing share of tax revenue to service the accumulated debt *together* → **shrinking fiscal policy space** for individual countries.

- In the *Economic Policy* article, Guiso, Herrera, Morelli and Sonno (2019) argue that the perception of such shrinking fiscal policy space plus the reality in Euro-zone countries that monetary policy is also not an individual country level policy tool, gave rise to a *straight jacket* perception that, interacted with globalization threats, turned out to be the main driver of populism voting (and not globalization alone).

- **Paradox:** While many new threats are global and the national policy space is shrinking, the populist response goes towards nationalism, and this reduces the possibility to resolve the economic insecurities at the source of populism itself.

Nationalism vs Globalism dimension

- Shayo, Tabellini Gennaioli, Besley Persson, Piketty, Nouri and many others find the nationalism vs globalism cleavage is becoming the dominant one, whereas in the past it was mostly left-right.
- The emergence and increasing relevance of the global vs national dimension is not exogenous:
    - Changes of strategy of many parties, which decide to pander offering more protection from immigrants and global competition;
    - Strategic choice by right-wing parties to emphasize the external threats, in order to attract some of the poor and economically insecure who otherwise on the economic dimension would go left.
    - Moving towards nationalism helps the rich because distracts the people from asking more redistribution.

Model

- Consider an economy with one firm, with production function

$$F(K, L) = aKL.$$

- Let the total population of potential workers be denoted by N, and each worker earn a wage of w. For a given wage w, and for a given aggregate demand G, the firm hires $L = \min\{N, G/(aK)\}$ workers, as long as

$$aK - w > 0$$

- If $G \geq \bar{G} \equiv aKN$, then the economy is in full employment, and hence any $w \in [u, aK]$ yields the same total welfare.

Unemployment and taxation

- ▶ If $N > G/(aK)$, the economy displays unemployment, and hence the State that wants to guarantee subsistence to all should raise tax revenue equal to $u(N - G/(aK))$.

- ▶ The **minimum** tax rate necessary to guarantee subsistence to all is

$$\underline{\tau} = \frac{u(N - G/(aK))}{G}. \tag{1}$$

- ▶ The tax rate must also have **two upper bounds**, since if it is too high then either the workers or the firm may obtain a payoff below subsistence or a negative profit, respectively. These two incentive compatibility constraints are:

$$(1 - \tau)G - wG/(aK) \geq 0 \;\leftrightarrow\; \tau \leq \bar{\tau} \equiv 1 - w/(aK) \tag{2}$$

and

$$(1 - \tau)w \geq u \;\leftrightarrow\; \tau \leq \hat{\tau} \equiv 1 - u/w. \tag{3}$$

Fiscal space

- For any given w, we will call **fiscal space** (FS) the distance between $\underline{\tau}$ and $\min\{\bar{\tau}, \hat{\tau}\}$
- For $w \geq \sqrt{uaK}$ $FS = \bar{\tau} - \underline{\tau} = \frac{G-(w-u)G/(aK)-uN}{G}$ increasing in G;
  whereas for $w < \sqrt{uaK}$ $FS = \hat{w} - \underline{\tau} = \frac{G(1-u/w+u/(aK))-uN}{G}$, also increasing in G.
- Thus, even if w is already low enough, less than $\sqrt{uaK}$, FS becomes empty (*political crisis*) when
  $G < \underline{G} \equiv \frac{N}{1/u-1/w+1/(aK)} > 0$.

Comparative statics

- Therefore political crisis more likely
  1. in a bigger economic crisis;
  2. with larger population of workers (fear of immigration);
  3. for higher subsistence needs;
  4. for smaller wages (perhaps caused by globalization);
  5. for higher role of capital (robots).
- All these things happened in the 21st century, leading to populist attempts to break away from one or more constraint creating the empty fiscal-political space.

Evaluating the consequences of a given economic crisis

- Consider a fixed economic crisis by ΔG.

  1. If $G - \Delta G > \underline{G}$, then the political consequences amount to a need to change w and τ, and in principle even if w is fixed on the global market even τ alone suffices as a policy tool, hence the dominant variable remains redistribution.
  2. If $G - \Delta G < \underline{G}$, then temptation arises to (1) block the growth of N; (2) raise the wage by closing to external competition — both typical protection policies of populists.

- So the difference between the 1929 US crisis and the great recession of this century does not need to be in terms of the size Δ of the crisis, but due to the fact that the evolution of all the components of $\underline{G}$ determined a situation of type 2 instead of type 1 like in 1929.

Capital taxation and robots

- Automation increases the role of K, which raises $\underline{g}$, which makes it more likely to fall in a political crisis if the only policy tool remains the *income* tax.

- At the national level capital taxation is not possible, due to tax competition – race to the bottom.

- So an alternative to populism (which aims to block N or increase w via protectionism) is pushing for global taxation of capital, up to the point sufficient to eliminate the political crisis determined by an empty income fiscal space.

The nationalism paradox

- If the automation process indeed will happen to be the largest threat to labor and to tax revenues at the national level, the nationalism direction will further exacerbate the trap. Less fiscal space implies wanting to reduce N and raise w, but doing so when at the same time the economy becomes robotized and tax revenues go down implies even smaller fiscal space, a vitious circle.

- The only way to restore viability of the overall capitalist economy, the sum of all the economies of all countries, is to globally find a solution to tax competition, so that replacement of labor with robots does not determine a systematic reduction of tax revenues and a balooning of subsistence problems that cannot be compensated by a defunct welfare.

- For now the problem has been softened by creating fiscal space through the back-door of quantitative easing.

Conclusion

- Winners win more than what other lose from open markets, but the question is whether redistribution from winners to losers is fiscally or politically feasible, and if not then rational majority support for protectionism.

- If redistribution has to occur only at national level, then shrinking tax base on shrinking labor share and larger class of unemployed and pensioners needing welfare makes for a clear trap.

- Only way to face the global threats is with global solutions, global capital tax, or capital tax requirement to allow a country to join WTO – *issue linkage*.