PKSG Policy Note

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Fiscal Policy: Its Role in an Independent Scotland

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In this paper we consider the implications for macroeconomic fiscal policy in Scotland if the Scottish electorate votes in favour of independence in the referendum on 18 September, 2014. We offer the paper in the spirit of the new thinking that the Scottish government's Fiscal Commission has argued will be required if the potential benefits from the exercise of independently determined macroeconomic policy instruments are to be achieved.

The paper is organised into eight sections as follows:

1. Introduction

In a recent Discussion Paper the Scottish government identified a competitive rate of corporation tax (CT) as a key driver of economic growth and an essential component of its overall growth strategy.

2. Neoclassical Fiscal Policy and Macroeconomics

The neoclassical theory on which the above Discussion Paper is based, suffers, in our opinion, from a lack of congruence between its micro- and macroeconomic elements. Its conclusions derive from models based on questionable theoretical concepts such as the representative agent and the aggregate production function and are potentially misleading.

3. Income Distribution and Consumption Propensities

Inequalities in income distribution are increasingly recognised as a factor influencing economic growth. This leads to the importance of distinguishing between wage-led and profit-led economies. It is necessary to establish into which category Scotland falls as this has important implications for fiscal policy. There is a potential inconsistency between the Scottish government's intention of using CT as a means of achieving its twin objectives of boosting sustainable growth and reducing income inequality.

4. A Kaleckian Growth Model and Taxation

We employ a model deriving from the writings of the Polish economist M. Kalecki, co-founder with J. M. Keynes of modern macroeconomics, to explore the relationship between taxation and economic growth. This model analyses the effects of taxation on the rate of depreciation of capital equipment, the level of profits and the rate of capacity utilisation within a balanced budget framework in which the levels of government spending and taxation remain unchanged but substitutions are made between income tax (IT) and CT. Depending on whether or not either tax is shifted, substitutions between IT and CT can have a positive effect on economic growth.

5. A Behaviouralist Approach to Investment

Evidence supporting the relevance of Kalecki's approach is provided by a behaviouralist version of his investment theory which provides econometric support from the USA for the factors he argued determine investment.

6. Income Distribution and Growth

The recent global trend towards 'financialisation' and its effects on long-run economic development lends support for Kalecki's degree of monopoly theory of income distribution and the growth implications of increasing income inequality in favour of profits by reducing CT at the expense of labour income.

7. Capital Taxation

Kalecki identified taxation of capital as socially optimal on the grounds that it does not affect the net profitability of investment or discourage lenders from lending. This conclusion is the obverse of the neoclassical conclusion that capital taxes are distorting so that the optimal tax rate on capital should be zero.

8. Summary and Conclusions

The paper supports the aspiration of the Scottish government that the objectives of its economic policy are to create a society that is not only faster growing but more egalitarian in its distribution of income. This is a circle which we consider mainstream economic thought will have difficulty in squaring. We propose an alternative approach deriving from Kalecki for whom understanding the causes of inequalities in the distribution of income lies at the heart of economics. In our opinion, the only coherent integration of macroeconomics and fiscal policy derives from Kalecki. This requires an 180 degree shift in the focus of fiscal policy from the expenditure side of the government's budget to the revenue side. Growth can be stimulated by altering the structure and not the level of taxation.

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