

No Indeterminacy under the Balanced Budget
Rule

Fujio Takata

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Abstract

This article deals with how an economy moves when governments levy a labor income tax on the basis of a balanced budget rule. This rule means that while government spending is a given, the government decides only tax rates, in order to equalize tax revenue and spending. We rely on an infinite horizon model. Schmitt-Grohé and Uribe (1997) focuses on the issue and affirms that for some ranges of tax rates indeterminacy can occur. However, since the conclusion has serious flaws, we carefully refute it and mathematically demonstrate that contrary to Schmitt-Grohé and Uribe (1997), there is no possibility of indeterminacy.

In short, the economy can converge to two steady states in the long term; one with superior, the other with inferior economic performance, in general. But the two states are indifferent with regard to production efficiency, which is shown in terms of capital–labor intensity. Which state our economy converges to depends on initial conditions. Therefore, we should be more careful about initial conditions, especially about the labor income tax rates, in order to guide our economy to better performance.