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# FINANCIAL REPRESSION AND PUBLIC FINANCE IN A CALIBRATED GENERAL EQUILIBRIUM MODEL

## Abstract:

This paper uses a simple calibrated general equilibrium model to evaluate the impact of financial repression in the form of non-market placement of public debt. By imposing a requirement for households to hold public debt with a below-market rate of return the government distorts optimal household allocation. Financial repression proceeds as an indirect distortionary taxation, which decreases propensity to consume and increases labor supply. It crowds-out private capital, but has an ambiguous impact on output. The composition of government revenue from taxation changes as well. Tighter financial repression shifts Laffer curves for taxes on labor and consumption down, but increases revenue from capital income taxation. Total budget revenue increases, which allows financing more public goods. We describe the substitutability between financial repression and regular taxation. Abandoning financial repression (increasing the interest rate on public debt) requires a substantial increase in the capital tax rate, which provides a political reasoning for pursuing less visible financial repression. For the U.S., loosening the requirement for private agents to hold public debt should be compensated by heavier regular taxation to keep total budget revenue constant, while European governments can simultaneously decrease the regular tax burden and have smaller public debt to finance the same amount of public goods.

## Keywords:

financial repression; tax distortions; public debt; Laffer curve

**JEL Classification:** E62, H27, H63