

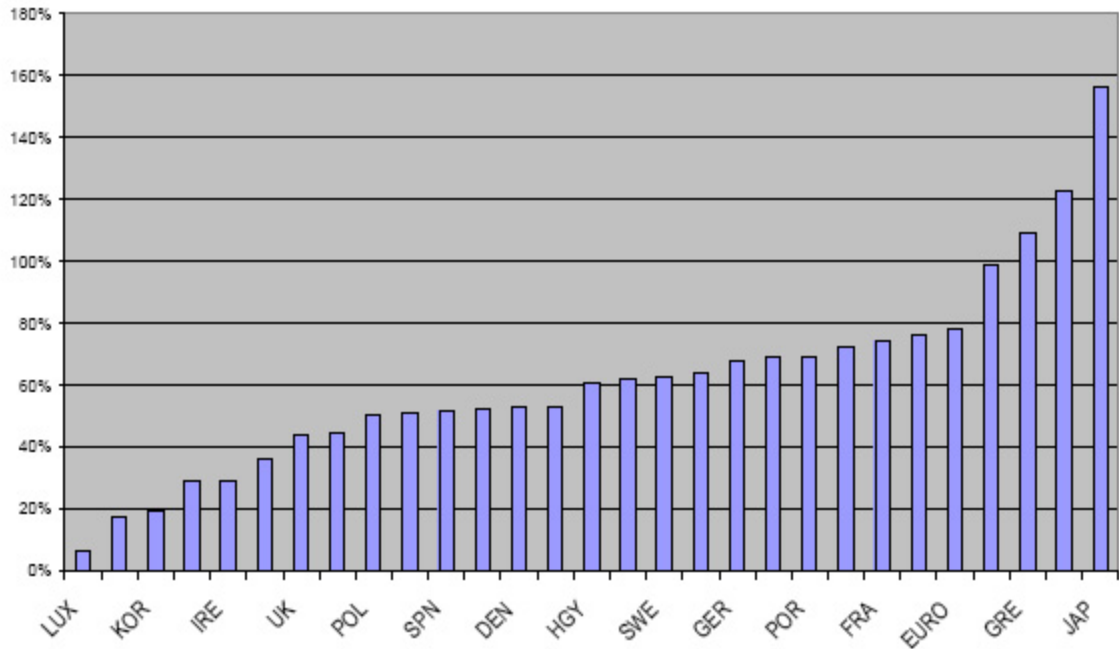
# **A Positive Theory of Government Debt**

## **Discussant Comments**

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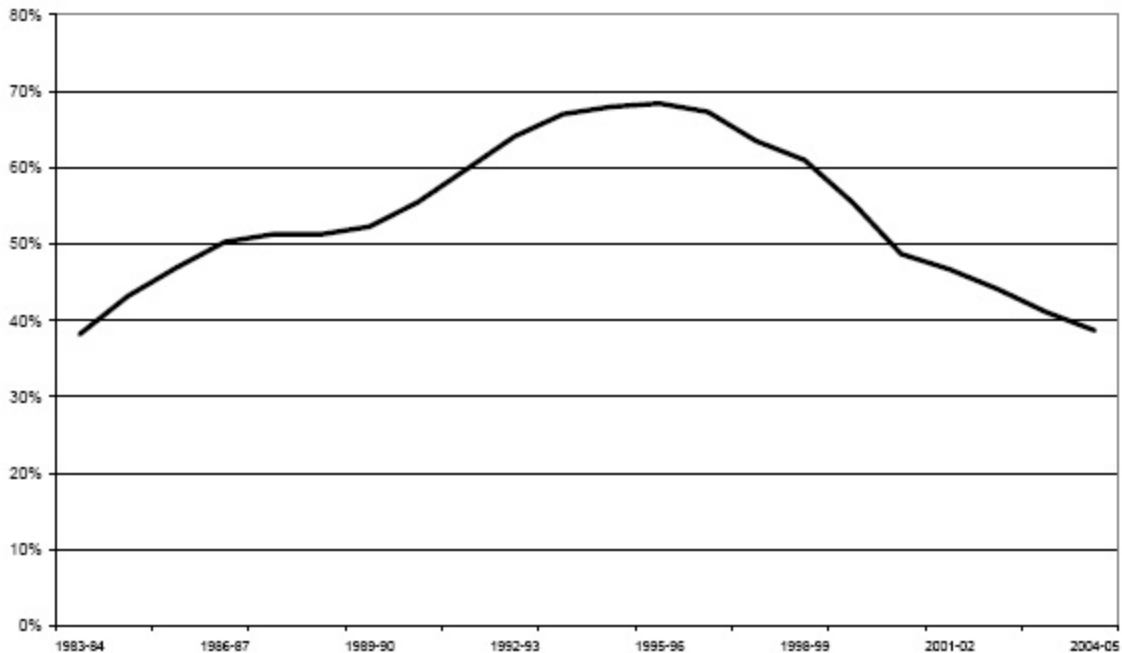
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General Government Debt, 2004  
Percent of GDP, Consolidated



Source: OECD (2006)

Canadian Federal Government Debt/GDP Ratio  
1983-2004



## Quick Summary

**Goal:** Develop a purely 'economic' explanation of gov't debt levels

**Approach:** Extends Lucas & Stokey (1983), Gov't taxes labour, issues debt & prints money to fund public expenditures; Calibrates to U.S. data

**Result:** Gov't debt depends on HHs ability to avoid inflation tax, not fundamentals

**Intuition:** Gov't views inflating as:

*Non-distortionary today:*  $\downarrow$  real value of debt ( $\pi$  more attractive at higher debt)

*Distortionary tomorrow:* HH's substitute to non-cash goods ( $c_2, l$ )

(low substitutability  $\Rightarrow$  high distortion  $\Rightarrow$   $\pi$  costly so gov't issues debt)

# Successes

- Model can deliver:
  - an interior steady-state debt level, independent of initial conditions
  - interesting debt dynamics when spending is stochastic
- Emphasizes govt's lack of commitment
- Nicely summarizes govt's trade-off b/w current and future distortions

# Issues

- Results rely heavily on an unobserved and unestimated parameter,  $\rho$
- Model has trouble generating high debt levels (unlikely explanation of observed cross-section dispersion)
- Debt's insensitivity to fundamentals may suggest a political/institutional approach, which has some empirical support  
(coalitions; alternating governments; budget centralization; accountability)

## Possible Extensions

- Model dynamics may be useful to explain time-series dimension:
  - Given observed spending, can the model explain the U.S. debt path?
  - Why debt rose in many dvlpd countries during *peacetime*?
  - Fiscal adjustments (Why do some countries delay?)
- Investigate complementarities b/w fiscal and monetary policy by comparing high & low inflation environments

In model, gov'ts prefers inflating to taxing labour at high debt levels

Generally consistent with historical evidence

## Potential Additional References

- Drazen, A. (2000) Political Economy in Macroeconomics
- Kocherlakota, N. (2005) "Advances in Dynamic Optimal Taxation", mimeo.
- Roubini, N. and Sachs, J. (1989) "Political and Economic Determinants of Budget Deficits in the Industrial Democracies" *EER*
- Velasco, A. (2000) "Debts and Deficits under Fragmented Fiscal Policymaking." *JPE*.