

Discussion of Halac-Yared
“A Theory of Fiscal Responsibility and
Irresponsibility”

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Fiscal Policy in an Era of High Debt
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Context

- Often observe
 - Periods of relatively lax fiscal policies
 - Followed by tight budgets/austerity
 - And the cycle repeats
 - E.g. Populist cycles, Dornbush-Edwards
- At odds with usual consumption/tax-smoothing logic
- Question: How can rationalize these patterns as *efficient* outcome given primitive frictions
 - Information, commitment, political-economy, etc ...

This Paper

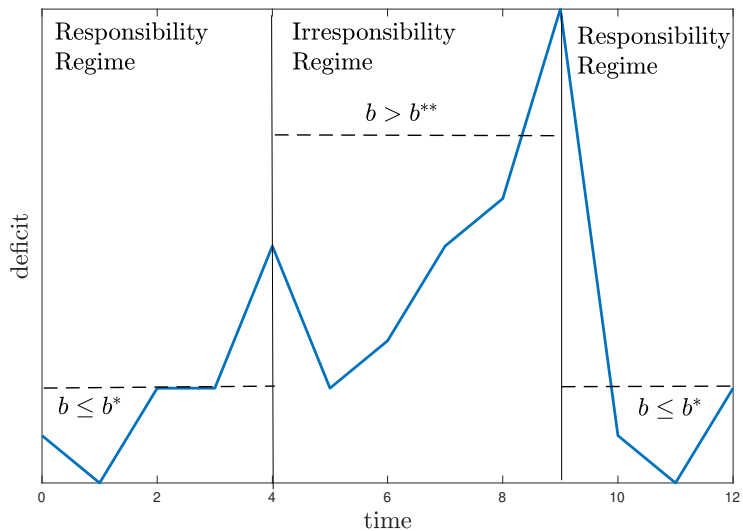
Optimal foreign borrowing (incomplete markets) subject to

- Present bias
 - Society's preferences: $V_t = \theta_t u(g_t) + \beta V_{t+1}$
 - Government's preferences $W_t = \alpha \theta_t u(g_t) + \beta V_{t+1}$ with $\alpha > 1$
- Private information
 - θ_t is privately observed by gov't in period t
- Lack of commitment
 - Best SPE

Main Results

- Bang-bang property
 - Continuation values for best SPE is either best or worst SPE
 - $\bar{V}(\mathbf{b}_t) \in \{\bar{V}(\mathbf{b}_{t+1}), \underline{V}(\mathbf{b}_{t+1})\}$
 - Companion paper: Halac-Yared (22) ECMA
- Best SPE outcome has two regimes:
 - **Fiscal responsibility regime**
 - Stay if $\mathbf{b}' \leq \mathbf{b}^*$
 - Exit if $\mathbf{b}' > \mathbf{b}^*$
 - **Fiscal irresponsibility regime**
 - Stay if $\mathbf{b}' \leq \mathbf{b}^{**}$
 - Exit if $\mathbf{b}' > \mathbf{b}^{**}$
- Fiscal responsibility not absorbing if present bias intermediate

Typical equilibrium outcome



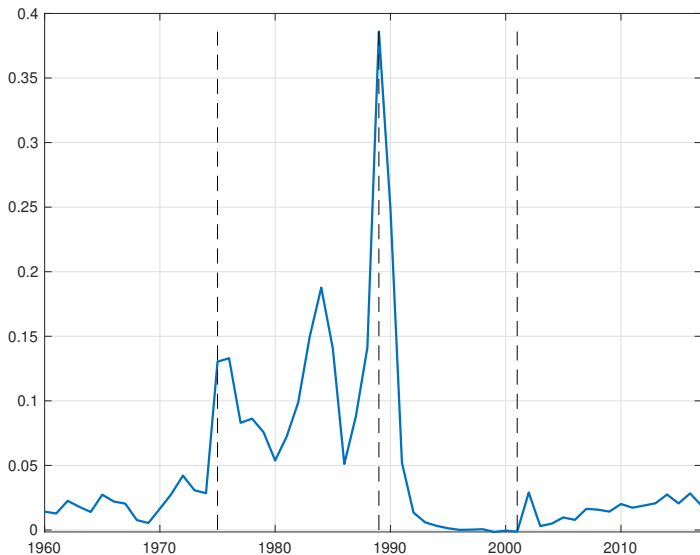
Main empirical prediction

- **Transit to next regime after a big “bad” realization**
 - Common to economies with bang-bang property
 - Green-Porter, APS (hidden action)
 - Atkeson-Chari-Kehoe

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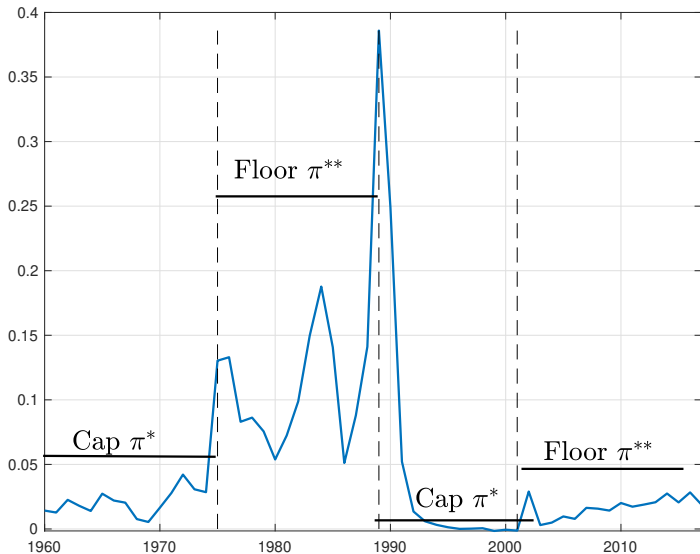
- **Transit to next regime after a big “bad” realization**
 - Common to economies with bang-bang property
 - Green-Porter, APS (hidden action)
 - Atkeson-Chari-Kehoe
- Cannot be replicated by
 - Reputation models a la Milgrom-Roberts, Kreps-Wilson
 - After bad policy \rightarrow lose reputation
 - Want reform w/ tight limit but hard to convince market
 - Dovis-Kirpalani
 - Risk-sharing arrangement with frictions
 - Atkeson, Amador-Aguiar-Gopinath, Dovis
 - Monotonicity in b
- Dovis-Golosov-Shourideh
 - Best SPE has populist cycles: high (low) $b \Rightarrow$ low (high) b'
 - Need two state variables: debt and domestic inequality
 - Cycles die out without shocks

Argentina: Inflation



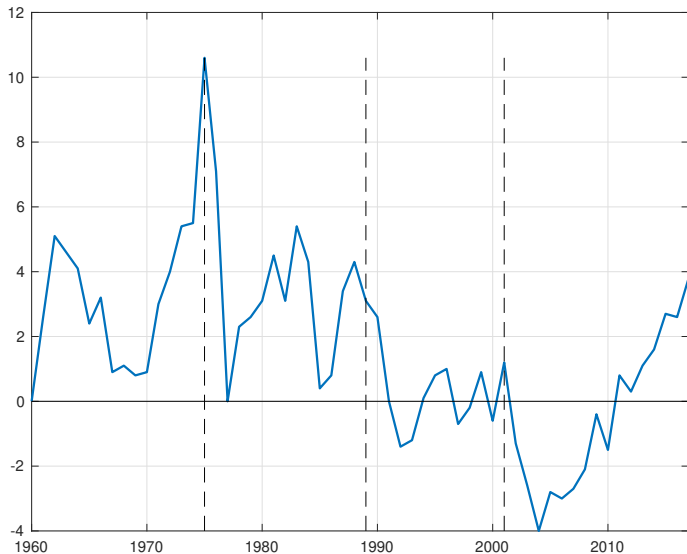
Source: Kehoe-Nicolini, Monetary and fiscal history of Latin America

Argentina: Inflation



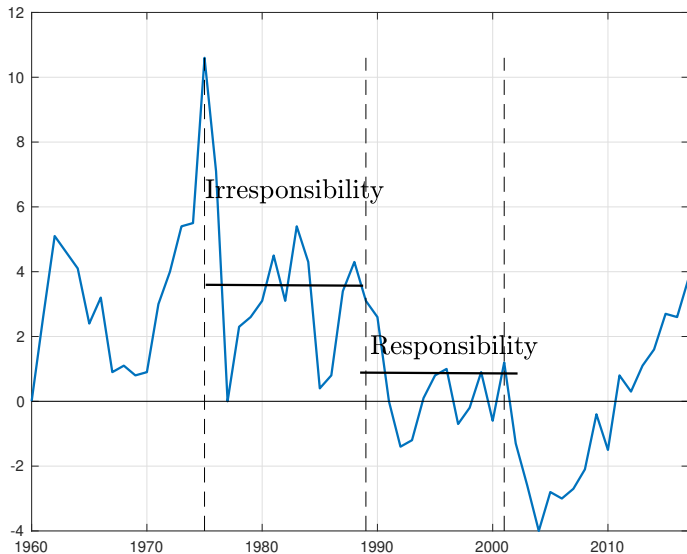
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Argentina: Primary deficit



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Role of present bias for multiple regimes

- Transition from two regimes if present bias intermediate
 - For any discount factor sufficiently high, $\exists (\alpha_L, \alpha_H)$ such that the best equilibrium has two regimes: responsibility \rightleftharpoons irresponsibility
 - High δ needed so discretion not unique equilibrium
 - Low α : no disagreement so give full discretion, no punishment
 - High α : relatively lax debt limits, too costly to provide incentives
 - Intermediate α : punish gov't that overspend better than relaxing debt limit for other gov't types
 - How to think about relevance of the mechanism across countries with different biases?
 - Measured by government turnover, political polarization, etc.
- Implications for amount of discretion and frequency of transitions

Conclusion

- Great paper
- Theory to rationalize dynamics between responsibility and irresponsibility regime with three frictions:
 - Present bias
 - Private information
 - Lack of commitment
- Help rationalize why responsibility regime can happen after occurrence of “bad” policies