Public debt and fiscal policy traps

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Abstract

We present a theory linking the cyclicality of tax policy to inherited public debt. When debt is low, tax policy is countercyclical, in the sense that the government responds to low output by setting a low tax rate. Above a threshold level of debt, however, optimal tax policy becomes procyclical. This creates the possibility of self-fulfilling crises (“fiscal policy traps”), in which output is low because households expect high taxes, and the government sets high taxes because output is low. Our model suggests why highly indebted governments might implement procyclical tax policy even without facing high sovereign risk premia.

Keywords: Public debt, Tax policy cyclicality, Coordination failures, Expectation traps, Laffer curve

JEL: E62, H63

1. Introduction

Public debt to GDP ratios in advanced economies have been rising since the mid-1970s, and have recently reached levels not seen since just after World War II (Abbas et al., 2011). The recent financial crisis and the ensuing Great Recession exacerbated this trend through bailouts, stimulus packages, rising unemployment claims, and falling tax revenues. This has led to a heated debate over the pace of fiscal consolidation, with one side emphasizing the burden on...

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