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Intertemporal budget policies and macroeconomic adjustment in a small open economy☆

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Abstract

This paper analyzes the role of nominal assets in ranking intertemporal budget policies in a growing open economy. Budget policies are ranked in terms of the public's intertemporal tax liability. In our small open economy model, the constraint for the valuation of private and public financial assets is in terms of the exogenous foreign price level. We show that this limits, under purchasing power parity, the scope of the government to influence the real value of financial assets using fiscal and monetary policy instruments.
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1. Introduction

An enduring topic of economic policy is the study of the effects of changes in fiscal and monetary instruments on the financial position of the public sector. Indeed, discussions in the political arena often revolve around the question of the response of policy to current fiscal deficits or surpluses. An oft-cited justification of tax cuts is that they pay—at least partially—for themselves, since they also increase the level of economic activity and, consequently, the tax base.[2] This issue has been revisited recently as researchers have applied the insights of endogenous growth theory to the relationship between fiscal policy decisions and the dynamic evolution of the government budget.[3] The newer research, exemplified by Ireland (1994) and Bruce and Turnovsky (1999), considers the effect of government expenditure and tax policy not only on the growth rate of the economy, but also on the growth rate of the tax base, the path of government debt, and the value of *future* tax payments required to maintain the intertemporal solvency of the public sector.[4] Bianconi (1999) extends the work of Bruce and Turnovsky (1999) by introducing nominal assets—and hence an inflation tax—into his analysis. He finds that the existence of nominal assets introduces another channel through which changes in fiscal policy can affect the long-term tax liability of the private sector. Through the mechanisms of greater inflation tax revenue and price level effects that lower the burden of the public sector real debt, Bianconi (1999) shows that changes in both government expenditure and tax policy can reduce the long-run tax liability. He supports these analytical results with numerical simulations that suggest that the role of nominal assets in determining future tax liabilities may be of empirical relevance.

In this paper we extend this analysis to a small open economy that includes nominal assets. We think this is an useful extension in light of the increasing integration of the world economy and because rules enforcing public sector financial stability are becoming a more important part of multilateral economic agreements, such as the Maastricht criterion for European monetary integration. We develop a single-good, small open economy model in which physical capital accumulation, as in Turnovsky (1996, 1997), is the engine of economic growth. In addition to spending real resources, the government in our model levies lump-sum and income taxes and issues internationally traded bonds and domestic money balances. We consider the

[2] Early discussions of the supply-side impact of tax cuts focused on whether a reduction in the marginal tax rate on labor income would lead to an increase in tax revenues through greater work effort. The empirical consensus that emerged subsequently was that the response of labor supply to changes in the after-tax real wage, at least in the United States, was too small to generate such Laffer-curve effects. See Laffer (1979) for an early statement of the potential supply-side effects of tax reductions. More recently, Slemrod (1994) found evidence that a Laffer-curve effect holds for high-income earners.

[3] Authors who analyzed the influence of government expenditure and tax policy on the equilibrium rate of growth include, among others, Barro (1990), Jones and Manuelli (1990), Rebelo (1991), and Jones et al. (1993).

[4] Bruce and Turnovsky (1999) also derive the conditions for the implementation of welfare-maximizing fiscal policy. Agell and Persson (2001) also consider this question. While this is not our concern here, our model can be employed to address this issue.

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