Restoring sustainable public finances after the crisis: what can we learn from Alesina and Tanzi

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A framework for discussion

$$-pb + \left(\frac{1+i}{(1+g)(1+\pi)} - 1 \right) d_{t-1} = \Delta d$$

pb	= primary balance (ratio to GDP)
d	= debt ratio to GDP
i	= effective nominal bond yield
g	= real growth rate of the economy
π	= inflation rate

A menu of five scenarios

$$-pb + \left(\frac{1+i}{(1+g)(1+\pi)} - 1 \right) d_{t-1} = \Delta d$$

1. *Consolidate*. If well targeted, this will also raise g alongside pb.
2. *Reform*. Structural reforms can raise potential growth g.
3. *Inflate*. Monetary stimulus, talking up inflation expectations, QE, to raise π (and g?).
4. *Mimic Japan*. Accept ever-rising debt ratio to GDP, without defaulting.
5. *Restructure or bail out*. This would either lower i, d_{t-1}, or both, hitting bond holders, or tax payers.

Scenario 3 (inflation): won't work

Tanzi:

- *Maturities are too short*. The effect will be small as i quickly increases with π (Fisher parity)
- *Monetary policy independence should be preserved*. Monetisation blurs the distinction between fiscal and monetary policy. Already happened with QE (subsidy to car producers, home owners, financial industry).

Scenario 4 (Japan): won't work

Tanzi:

- *Japan is unique.* High saving, large current account surplus, strong exchange rate, low expected return on capital outflow. So i is contained. Not true for many others.
- *Nominal interest rates will soar before the economy recovers*. You get a high i, investors won't tolerate high debt.
- *Or real interest rates will soar*. Even if i remains the same, it is because deflation is looming. You get a negative π and therefore a high i- π.
- *Growth will fall*. See Reinhart and Rogoff: g will fall if d stays high, so high welfare cost.

Scenario 1: first best!

- *Krugman is wrong (Tanzi)*. Fiscal multipliers are zero or negative (confidence effects). Fiscal policy that perpetuates macroeconomic imbalances lowers *g*.
- *Hysteresis argument is bogus (Tanzi)*. No point in responding to high unemployment, which is a lagging indicator.
- *Smaller government is good*. Get rid of wastage and tax churning (Alesina). Government size of 30-35% is optimal (Tanzi).
- *Voters like it*. Fear of electoral damage is misguided, especially in a crisis (Alesina). But must be fair (Tanzi). After bailing out the losers, tax the winners.

Both are silent on other scenarios

- *Both are relatively silent on structural reform (scenario 2).* Can structural reform be used as an instrument of fiscal consolidation (either on its own or in combination with other instruments)?
- *Both are silent also on debt restructuring or bail-out (scenario 5).* Is it because default is the default? Can orderly default be a deliberate choice?