What is a sustainable public debt?

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The views expressed here do not necessarily reflect those of the Federal Reserve Bank of Chicago, the Federal Reserve Bank of Philadelphia or the Federal Reserve System.
Public debt sustainability

• Literal definition: *a sustainable debt is that which can be maintained at a certain rate or level*

• In macro literature:
  1. **Under commitment**: debt consistent with solvency (IGBC) and/or a stationary equilibrium
  2. **Without commitment**: debt supported in equilibria with default risk

• Critical question in fiscal policy analysis
  – 2008-11, debt ratios rose by 31 (20) ppts. in U.S. (Europe)
  – Global market of local-currency gov. bonds was 1/2 of world’s GDP in 2011 ($30 trillion, 6 times investment-grade external sov. debt)
1. Critical review of “classic” approach

2. *Empirical approach*: Bohn’s Fiscal Reaction Function

3. *Structural approach*: Two-country DGE with fiscal sector that matches actual tax base elasticities

4. *Domestic default approach*: Model of optimal default driven by distributional incentives

5. New applications to U.S. and cross-country data, and analysis of their implications
Generic government budget constraints

• Period GBC with Arrow gov. securities:

\[
\sum_{s_{t+1}} Q_1(s_{t+1}|s_t)b_t(s_{t+1}|s^t) - b_{t-1}(s_t|s^{t-1}) = g(s_t) - \tau_t(s^t).
\]

– In GDP ratios and under perfect foresight:

\[
b_t - (1 + r_t)b_{t-1} = -pb_t \quad \quad r_t \equiv \frac{(1 + \bar{r}_t)}{(1 + \gamma_t)} - 1
\]

• NPG condition + arbitrage yields IGBC:

\[
b_{t-1} = pb_t + \sum_{j=1}^{\infty} E_t[MRS(c_{t+j}, c_t)pb_{t+j}] \quad \quad pb_t \equiv \tau_t - g_t
\]
Classic approach

- Proposed by Buiter (1985), Blanchard (1990), and widely used in policy institutions (IMF, 2015)
- At steady-state & under perfect foresight, GBC yields “Blanchard ratio” (debt-stabilizing $pb$):

$$b^{ss} = \frac{pb^{ss}}{r}$$

- First flaw: Disconnected from initial debt and IGBC
  - FRFs with different coefficients satisfy IGBC for same initial debt but converge to different steady states, and can even go to infinity!
• Second flaw: Ignores uncertainty & asset markets

• Mendoza & Oviedo (06, 09): under incomplete markets, adding shocks + smoothing (or tolerable min. outlays) yields “Natural Public Debt Limit:”

$$b_t \leq NPDL \equiv \frac{\tau_{\text{min}} - g_{\text{min}}}{ir - \gamma}$$

– Blanchard ratio uses l.r. means (always violates NPDL)
– NPDL tighter for economies with more volatile revenues or less able to adjust outlays
– Debt follows random walk with boundaries:

$$b_t = \max[NPDL, (1 + r_t)b_{t-1} - pb_t] \geq \bar{b}$$
Argentina: Simulated debt dynamics

(starting from 30% debt, calibrated revenue process, $g^{\text{min}}=12.4$, NPDL=55.7)
Empirical Approach: Bohn’s Contributions

1. IGBC tests discounting at risk free rate are misspecified:

   \[ b_{t-1} = pb_t + \sum_{j=1}^{\infty} \left[ \frac{E_t[pb_{t+j}]}{R_{t+j}} + cov_t (MR.S(c_{t+j}, c_t), pb_{t+j}) \right] \]

2. IGBC holds if debt or outlays+interest are integrated of any finite order (no particular integration order needed)

3. Linear FRF \[ pb_t = \mu_t + \rho b_{t-1} + \epsilon_t \], with \( \rho > 0 \) is sufficient for IGBC (debt is stationary if \( \rho > r \), or diverges to infinity if \( 0 < \rho < r \) but is still sustainable!

4. Empirical tests based on historical U.S. data 1791-2003 support linear FRF and some nonlinear variations
New FRF Estimates

• U.S. estimates (1791-2014) and cross-country panels (1951-2013) again pass sufficiency test
  – EMs have stronger response, less access to debt

• Structural break post-2008 (lower response, large residuals, large primary deficits)

• U.S. deficits larger than in previous “debt crises,” much larger than out-of-sample pre-08 forecast

• FRFs with lower response coefficient satisfy IGBC at same initial debt, but with larger deficits & higher long-run debt
Public Debt Crises in U.S. History
(net federal debt-GDP ratio, 1791-2014)

- Civil War
- WWI
- Great Depression
- WWII
- Great Recession
## New FRF Estimates: U.S. 1792-2014

<table>
<thead>
<tr>
<th>Model:</th>
<th>Base model (1)</th>
<th>Asymmetric response (2)</th>
<th>AR(1) term (3)</th>
<th>Debt Squared (4)</th>
<th>Time trend (5)</th>
<th>Bohn’s Sample (1793-2003)</th>
<th>Pre-Recession (1793-2008)</th>
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<tbody>
<tr>
<td>Coefficient</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Constant</td>
<td>0.00648</td>
<td>0.00540</td>
<td>0.00974</td>
<td>0.00653</td>
<td>0.00601</td>
<td>0.00485</td>
<td>0.00470</td>
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<tr>
<td></td>
<td>(0.004)</td>
<td>(0.003)*</td>
<td>(0.008)</td>
<td>(0.004)</td>
<td>(0.006)</td>
<td>(0.003)*</td>
<td>(0.003)</td>
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<tr>
<td>Initial debt $d_t^*$</td>
<td>0.07779</td>
<td>0.08689</td>
<td>0.10477</td>
<td>0.07715</td>
<td>0.07674</td>
<td>0.10498</td>
<td>0.10188</td>
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<tr>
<td></td>
<td>(0.040)*</td>
<td>(0.030)**</td>
<td>(0.032)**</td>
<td>(0.038)*</td>
<td>(0.035)**</td>
<td>(0.023)**</td>
<td>(0.022)**</td>
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<tr>
<td>GDP gap</td>
<td>0.07404</td>
<td>0.07300</td>
<td>0.15330</td>
<td>0.07390</td>
<td>0.07490</td>
<td>0.07987</td>
<td>0.07407</td>
</tr>
<tr>
<td></td>
<td>(0.078)</td>
<td>(0.079)</td>
<td>(0.043)**</td>
<td>(0.079)</td>
<td>(0.077)</td>
<td>(0.086)</td>
<td>(0.086)</td>
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<tr>
<td>Military Expenditure</td>
<td>-0.72302</td>
<td>-0.72001</td>
<td>-0.98955</td>
<td>-0.72320</td>
<td>-0.72462</td>
<td>-0.77835</td>
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<tr>
<td></td>
<td>(0.133)**</td>
<td>(0.136)**</td>
<td>(0.110)**</td>
<td>(0.133)**</td>
<td>(0.135)**</td>
<td>(0.135)**</td>
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<tr>
<td>max($0, d_t^* - d$)</td>
<td>-0.14487</td>
<td></td>
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<td></td>
<td>(0.061)</td>
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<tr>
<td>AR(1)</td>
<td>0.89154</td>
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<tr>
<td></td>
<td>(0.029)**</td>
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<tr>
<td>$(d_t^* - d)^2$</td>
<td>0.00261</td>
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<td></td>
<td>(0.044)</td>
<td></td>
<td></td>
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<tr>
<td>Time trend</td>
<td>6.89E-06</td>
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<td></td>
<td>(5.9E-05)</td>
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</table>

Note: HAC standard errors shown in parenthesis, 2-lag window prewhitening. ***, ***, *** denote that the corresponding coefficient is statistically significant at the 90, 95 and 99 percent confidence levels. Output gap is percent deviation from Hodrick-Prescott trend. Military expenditure includes all Department of Defense and Department of Veterans Affairs outlays.
Debt Projections: Alternative FRFs

Note: For the US: Model (3) in table 1 is used in conjunction with estimated AR(2) processes for the output gap and military expenditure, plus the government budget constraint. For Europe: Model (5) in table 2 is used in conjunction with estimated AR(1) processes for the output gap and government consumption gap in each country, and a simple average among advanced European countries is taken.
Structural Approach

- FRFs with different parameters satisfy IGBC for same initial debt, but macro dynamics and welfare differ and FRFs can’t compare them.

- Use calibrated variant of workhorse two-country Neoclassical model to compare fiscal adjustment policies in response to initial debt shocks.

- Match observed elasticities of tax bases to tax changes by introducing endogenous utilization and limited depreciation tax allowance.
Model highlights

- Deterministic setup with exogenous long-run growth driven by labor-augmenting technological change
- Fiscal sector includes taxes on capital, labor and consumption, gov. purchases, transfers and debt
- Utilization choice & limited tax allowance for depreciation
- Trade in goods and bonds (residence-based taxation)
- Capital immobile across countries, but trade in bonds arbitrages post-tax returns & induces capital reallocation
- Unilateral tax changes have cross-country externalities (relative prices, wealth distribution, tax revenues)
Households

• Maximize

\[
\sum_{t=0}^{\infty} \left[ \beta (1 + \gamma)^{1-\sigma} \right]^t \left( \frac{c_t (1 - l_t)^a}{1 - \sigma} \right)^{1-\sigma}, \quad \sigma > 1, \ a > 0, \text{ and } 0 < \beta < 1
\]

subject to:

\[
(1 + \tau_c) c_t + x_t + (1 + \gamma) (q_t b_{t+1} + q_t^g d_{t+1})
\]

\[
= (1 - \tau_L) w_t l_t + (1 - \tau_K) r_t m_t k_t + \theta \tau_K \bar{\delta} k_t + b_t + d_t + e_t,
\]

\[
x_t = (1 + \gamma) k_{t+1} - (1 - \delta(m_t)) k_t + \phi(k_{t+1}, k_t, m_t)
\]

given \( \{k_0, b_0, d_0\} \)
• Production technology:

\[ y_t = F(\tilde{k}_t, l_t) = \tilde{k}_t^{1-\alpha} l_t^\alpha, \text{ with } \tilde{k} = mk. \]

• Firms maximize profits

\[ y_t - w_t l_t - r_t \tilde{k}_t \]

• Optimality conditions equate marginal products with pre-tax factor prices
Fiscal sector

- Gov. purchases and transfers are exogenous and kept constant at initial steady-state levels

- GBC:
  \[ d_t - (1 + \gamma) q_t^g d_{t+1} = pb_t \]
  \[ \equiv \tau_C c_t + \tau_L w_t l_t + \tau_K (r_t m_t - \theta \bar{\delta}) k_t - (g_t + e_t) \]

- IGBC:
  \[ \frac{d_0}{y_{-1}} = \psi_0 \left[ \frac{pb_0}{y_0} + \sum_{t=1}^{\infty} \left( \prod_{i=0}^{t-1} v_i \right) \frac{pb_t}{y_t} \right] \]
  \[ v_i \equiv (1 + \gamma) \psi_i q_i^g, \quad \psi_i \equiv y_{i+1}/y_i \]
Tax distortions and externalities

- Asset markets arbitrage (ignoring capital adj.

\[
\frac{(1 + \gamma)u_1(c_t, 1 - l_t)}{\beta u_1(c_{t+1}, 1 - l_{t+1})} = (1 - \tau_K)F_1(m_{t+1}k_{t+1}, l_{t+1})m_{t+1} + 1 - \delta(m_{t+1}) + \tau_K \theta \bar{\delta} = \frac{1}{q_t} = \frac{1}{q_t^g}.
\]

\[
= (1 - \tau_K^*)F_1(m_{t+1}^*k_{t+1}^*, l_{t+1}^*)m_{t+1}^* + 1 - \delta(m_{t+1}) + \tau_K^* \theta \bar{\delta} = \frac{(1 + \gamma)u_1(c_t^*, 1 - l_t^*)}{\beta u_1(c_{t+1}^*, 1 - l_{t+1}^*)}
\]

- Labor market:

\[
\frac{u_2(c_t, 1 - l_t)}{u_1(c_t, 1 - l_t)} = \frac{1 - \tau_L}{1 + \tau_C} F_2(k_t, l_t) \quad (1 - \tau_W) \equiv (1 - \tau_L)/(1 + \tau_C)
\]

- Capacity utilization:

\[
F_1(m_t k_t, l_t) = \frac{1 + \Phi_t}{1 - \tau_K} \delta'(m_t),
\]
Calibration: Fiscal Heterogeneity

<table>
<thead>
<tr>
<th>GDP-weighted</th>
<th>EU</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macro Aggregates</strong></td>
<td></td>
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</tr>
<tr>
<td>$\tau_C$</td>
<td>0.17</td>
<td>0.04</td>
</tr>
<tr>
<td>$\tau_L$</td>
<td>0.41</td>
<td>0.27</td>
</tr>
<tr>
<td>$\tau_K$</td>
<td>0.32</td>
<td>0.37</td>
</tr>
<tr>
<td>$c/y$</td>
<td>0.57</td>
<td>0.68</td>
</tr>
<tr>
<td>$x/y$</td>
<td>0.21</td>
<td>0.21</td>
</tr>
<tr>
<td>$g/y$</td>
<td>0.21</td>
<td>0.16</td>
</tr>
<tr>
<td>$tb/y$</td>
<td>0.00</td>
<td>-0.05</td>
</tr>
<tr>
<td>Rev/y</td>
<td>0.45</td>
<td>0.32</td>
</tr>
<tr>
<td>Total Exp/y</td>
<td>0.47</td>
<td>0.39</td>
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<tr>
<th><strong>Debt Shocks</strong></th>
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<tbody>
<tr>
<td>$d_{2007}/y_{2007}$</td>
<td>0.38</td>
<td>0.43</td>
</tr>
<tr>
<td>$d_{2011}/y_{2011}$</td>
<td>0.58</td>
<td>0.74</td>
</tr>
<tr>
<td>$\Delta d/y$</td>
<td>0.20</td>
<td>0.31</td>
</tr>
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</table>
### Parameters from Data & Literature

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Description</th>
<th>Value</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\alpha$</td>
<td>Labor income share</td>
<td>0.61</td>
<td>Trabandt and Uhlig (2009)</td>
</tr>
<tr>
<td>$\gamma$</td>
<td>Growth rate</td>
<td>0.0038</td>
<td>Real GDP p.c. growth (Eurostat 2000–11)</td>
</tr>
<tr>
<td>$\omega$</td>
<td>Country size</td>
<td>0.46</td>
<td>GDP shares of the U.S. in 2008</td>
</tr>
<tr>
<td>$\sigma$</td>
<td>Risk aversion</td>
<td>2.000</td>
<td>Standard DSGE value</td>
</tr>
<tr>
<td>$\theta$</td>
<td>Depreciation allowance</td>
<td>0.20</td>
<td>$\frac{REV_{corr}^{KNR}}{REV^{K}}$ (Rev. Stat &amp; EUKLEMS)</td>
</tr>
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#### Fiscal Policy:

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Description</th>
<th>US</th>
<th>EU15</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>$g/y$</td>
<td>Gov’t exp share in GDP</td>
<td>0.16</td>
<td>0.21</td>
<td>OECD National Income Accounts</td>
</tr>
<tr>
<td>$\tau_C$</td>
<td>Consumption tax</td>
<td>0.04</td>
<td>0.17</td>
<td>MRT modified</td>
</tr>
<tr>
<td>$\tau_L$</td>
<td>Labor income tax</td>
<td>0.27</td>
<td>0.41</td>
<td>MRT modified</td>
</tr>
<tr>
<td>$\tau_K$</td>
<td>Capital income tax</td>
<td>0.37</td>
<td>0.32</td>
<td>MRT modified</td>
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### Parameters from Steady-State Conditions

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<th>Parameter</th>
<th>Description</th>
<th>Value</th>
<th>Source</th>
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</thead>
<tbody>
<tr>
<td>$\delta(\bar{m})$</td>
<td>depreciation rate</td>
<td>0.0163</td>
<td>steady state law of motion of capital</td>
</tr>
<tr>
<td>$\frac{x}{y} = \gamma - 1 + \delta(\bar{m})$</td>
<td></td>
<td></td>
<td>( \frac{x}{y} = 0.19, \frac{k}{y} = 2.62 ) (OECD and AMECO)</td>
</tr>
<tr>
<td>$\beta$</td>
<td>discount factor</td>
<td>0.998</td>
<td>steady state Euler equation</td>
</tr>
<tr>
<td>$\frac{(1+\gamma)^{\sigma}}{\beta} = 1 + (1 - \tau_K) (1 - \alpha) \frac{Y}{k} - \delta(\bar{m}) + \theta \tau_K \bar{d}$</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$\chi_0, \chi_1$</td>
<td>utilization</td>
<td>(0.023, 1.44)</td>
<td>match $\delta(\bar{m})$ and $\bar{m}$</td>
</tr>
<tr>
<td>$\eta$</td>
<td>adjustment cost</td>
<td>2.0</td>
<td>match the midpoint of empirical short-run elasticities of capital tax base to a 1% increase in $\tau_K$: [0.2, 0.5] Gruber &amp; Rauh 2007, Dwaenger &amp; Steiner 2012</td>
</tr>
</tbody>
</table>
Quantitative exercises

• Unilateral changes in capital or labor taxes
• “Passive” country adjusts to tax externalities in order to maintain revenue neutrality (changes labor tax)
• Construct dynamic Laffer curves (DLCs): change in PDV of primary balance (i.e. in sustainable debt)
• Compare against what is needed to make actual increases in debt sustainable (match “new” IGBC)
• Examine macro dynamics and welfare effects
• Perturbation method with shooting routine (accounts for steady-state dependency on initial conditions)
Main findings

- **Capital taxes:**
  1. Large externalities (strategic incentives)
  2. US: debt not sustainable (DLC max below required level)
  3. EU15: inefficient side of DLC (tax cut makes debt sustainable via external effects--closed-economy DLC also peaks below required level)
  4. Without utilization and limited allowance short-run tax elasticity has wrong sign and DLC is linearly increasing

- **Labor taxes:**
  1. Negligible externalities
  2. US lower initial taxes yield DLCs that sustain high debt
  3. EU15: DLCs (closed or open) peak below required level
Capital Tax Dynamic Laffer Curves

(a) US

(b) EU15
## Effects of Setting US Capital Tax at Max.

<table>
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<tr>
<th>Tax rates</th>
<th>Home</th>
<th>Foreign</th>
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<tr>
<td></td>
<td>Old</td>
<td>New</td>
</tr>
<tr>
<td>$\tau_K$</td>
<td>0.37</td>
<td>0.40</td>
</tr>
<tr>
<td>$\tau_C$</td>
<td>0.04</td>
<td>0.04</td>
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<tr>
<td>$\tau_L$</td>
<td>0.27</td>
<td>0.27</td>
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<table>
<thead>
<tr>
<th></th>
<th>Home</th>
<th>Foreign</th>
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<tbody>
<tr>
<td>$\Delta PV(\text{Primary Bal.})/y_0$</td>
<td>0.014</td>
<td>0.00</td>
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<tr>
<td>Welfare Impact</td>
<td>$-2.19$</td>
<td>$0.74$</td>
</tr>
<tr>
<td>$\Delta y_{ss}$</td>
<td>$-3.87$</td>
<td>$1.25$</td>
</tr>
</tbody>
</table>

*Note: Capital tax increase to maximum point of open-economy Laffer curve. Fore neutrality by lowering labor tax.*
### Capital Tax Base Elasticities: Models v. Data

<table>
<thead>
<tr>
<th>Elasticity</th>
<th>$y_1$</th>
<th>$l_1$</th>
<th>$m_1$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Empirical estimates</td>
<td>[0.1, 0.5]</td>
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<tr>
<td>Model Implications for the U.S.</td>
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</tr>
<tr>
<td>exog. utilization &amp; $\theta = 1$</td>
<td>$-0.09$</td>
<td>0.04%</td>
<td>0.011</td>
</tr>
<tr>
<td>exog. utilization &amp; $\theta = 0.2$</td>
<td>$-0.09$</td>
<td>0.08%</td>
<td>0.028</td>
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<tr>
<td>endog. utilization &amp; $\theta = 0.2$</td>
<td>0.29</td>
<td>$-0.15%$</td>
<td>0.010</td>
</tr>
</tbody>
</table>
U.S. Capital Tax DLCs: Alternative Models
Domestic Default Approach

• Previous two approaches cast doubt on chances of restoring fiscal solvency via conventional tools

• European crisis + historical evidence (Reinhart & Rogoff (11), Hall & Sargent (14)) raise possibility of domestic defaults
  – A “forgotten history” (R&R) until recently (D’Erasmo & Mendoza (2013,14), Dovis et al. (2014), ...)

• Remove commitment: Distributional incentives lead to default unless costs are sufficiently high or gov. favors bond holders
  – Solvency is not enough to make debt sustainable!
• Two-period model with two types of risk-averse agents (L, H), with fraction $\gamma$ of L-types ($b_0^L < b_0^H$)

• Gov. collects lump-sum taxes $\tau$, faces stochastic $g$, issues bonds $B$ ($g$ and default are non-insurable aggregate risks)

• Default is costly as a fraction $\phi(g)$ of income that varies with realization of $g$ (a’la Arellano (2008))

\[ \phi(g_1) \geq 0, \text{ with } \phi'(g_1) \leq 0 \text{ for } g_1 \leq \bar{g}_1, \phi'(g_1) = 0 \text{ otherwise} \]

• Gov. attains 2nd-best deviation from equal mg. utilities by redistributing via debt & default
Preferences:

\[ u(c_0) + \beta E[u(c_1)], \quad u(c) = \frac{c^{1-\sigma}}{1-\sigma} \]

Date-0 budget constraints and initial wealth for \( i=L,H \):

\[ c_0^i + q_0 b_1^i = y + b_0^i - \tau_0 \]

Date-1 budget constraints under repayment for \( i=L,H \):

\[ c_1^i = y + b_1^i - \tau_1 \]

Date-1 budget constraints under default for \( i=L,H \):

\[ c_1^i = (1 - \phi(g_1))y - \tau_1 \]
Payoff function for $i=L,H$:

$$v^i(B_1, \gamma) = \max_{b^i_1} \left\{ u(y + b^i_0 - q_0 b^i_1 - \tau_0) + \right.$$

$$\beta E_{g_1} \left[ (1 - d_1(B_1, g_1, \gamma)) u(y + b^i_1 - \tau^{d_1=0}_1) + d_1(B_1, g_1, \gamma) u(y(1 - \phi(g_1)) - \tau^{d_1=1}_1) \right] \right\}$$

subject to $b^i_1 \geq 0$

with initial bond holdings given by initial wealth distribution and bond market clearing:

$$b^H_0 = \frac{B_0 - \gamma b^L_0}{1 - \gamma} b^L_0 \geq 0$$
Government

Budget constraints

\[ \tau_0 = g_0 + B_0 - q_0 B_1 \]

\[ \tau^{d_1=0}_1 = g_1 + B_1 \quad \tau^{d_1=1}_1 = g_1 \]

Default optimization problem in 2\(^{nd}\) period (utilitarian SWF):

\[ \max_{d \in \{0,1\}} \{ W^{d=0}_1(B_1, g_1, \gamma), W^{d=1}_1(g_1, \gamma) \} \]

\[ W^{d=0}_1(B_1, g_1, \gamma) = \gamma u(y - g_1 + b^L_1 - B_1) + (1 - \gamma) u(y - g_1 + b^H_1 - B_1) \]

\[ W^{d=1}_1(g_1, \gamma) = u(y(1 - \phi(g_1)) - g_1) \]

Debt issuance optimization problem in 1\(^{st}\) period:

\[ W_0(\gamma) = \max_{B_1} \{ \gamma v^L(B_1, \gamma) + (1 - \gamma) v^H(B_1, \gamma) \} \]
Default Decision in 2\textsuperscript{nd} Period

- Assume bond demand choices given by:
  \[ b^L_1 = B_1 - \epsilon \text{ and } b^H_1(\gamma) = B_1 + \frac{\gamma}{1-\gamma}\epsilon. \]

- Socially optimal allocations (under repayment):
  \[ u'(y - g_1 + \frac{\gamma}{1-\gamma}\epsilon^{SP}) = u'(y - g_1 - \epsilon^{SP}) \iff \epsilon^{SP} = 0. \]

  - Zero consumption dispersion is first best
  - If default is costless, it is always optimal (attains 1\textsuperscript{st} best) and debt cannot be sustained.
    - Cost makes default suboptimal (for some bond demand choices dispersion is smaller with repayment)
    - Cost can be endogenized (liquidity, self-insurance) or replaced with gov. bias favoring bond holders
Equilibria with & without default costs
Equilibria with Government Bias
Debt Issuance Decision in 1\textsuperscript{st} Period

• Selling debt reduces dispersion at $t=0$, but increases it at $t=1$ under repayment:

$$c_0^H - c_0^L = \frac{1}{1 - \gamma} [B_0 - q(B_1, \gamma)B_1]$$

$$c_1^{H,d=0} - c_1^{L,d=0} = \frac{1}{1 - \gamma} B_1$$

$$c_1^{H,d=1} - c_1^{L,d=1} = 0.$$

• Gov. internalizes how the gain of issuing debt is hampered by default risk, which lowers bond prices (debt Laffer curve).
Debt Issuance Optimality Condition

- Without default, some dispersion is optimal (debt helps relax L-types borrowing constraint)

\[ u'(c_0^H) = u'(c_0^L) + \frac{\eta}{q(B_1, \gamma) \gamma} \{ \gamma \mu^L \} \]

\[ \mu^L \equiv q(B_1, \gamma) u'(c_0^L) - \beta E_{g_1} [(1 - d^1) u'(c_1^L)] > 0. \]

- With default risk, more dispersion at t=0 is traded off for possibly zero at t=1 in default states

\[ u'(c_0^H) = u'(c_0^L) + \frac{\eta}{q(B_1, \gamma) \gamma} \{ \beta E_{g_1} [\Delta d \Delta W_1] + \gamma \mu^L \} \]

\[ \Delta d \equiv d(B_1 + \delta, g_1, \gamma) - d(B_1, g_1, \gamma) \geq 0, \text{ for } \delta > 0 \text{ small}, \]

\[ \Delta W_1 \equiv W_1^{d=1}(g_1, \gamma) - W_1^{d=0}(B_1, g_1, \gamma) \geq 0, \]
Calibration to European Data

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount Factor</td>
<td>$\beta$ 0.96</td>
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<tr>
<td>Risk Aversion</td>
<td>$\sigma$ 1.00</td>
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<tr>
<td>Avg. Income</td>
<td>$y$ 0.79</td>
</tr>
<tr>
<td>Low household wealth</td>
<td>$b_0^L$ 0.00</td>
</tr>
<tr>
<td>Avg. Gov. Consumption</td>
<td>$\mu_g$ 0.18</td>
</tr>
<tr>
<td>Autocorrel. G</td>
<td>$\rho_g$ 0.88</td>
</tr>
<tr>
<td>Std Dev Error</td>
<td>$\sigma_g$ 0.017</td>
</tr>
<tr>
<td>Initial Gov. Debt</td>
<td>$B_0$ 0.79</td>
</tr>
<tr>
<td>Output Cost Default</td>
<td>$\phi_0$ 0.02</td>
</tr>
</tbody>
</table>

Note: Government expenditures, income and debt values are derived using data from France, Germany, Greece, Ireland, Italy, Spain and Portugal.
Equilibrium Manifold as Share of Non-debt-holders Rises (calibration to European data)
Equilibria with Government Bias

Panel (i): Debt Choice $B_1^*(\gamma)$

Panel (ii): Bond Price $q(B_1^*(\gamma), \gamma)$

Panel (iii): Spread (%)

Panel (iv): Default Probability $p(B_1^*(\gamma), \gamma)$
Non-bond-holders may prefer bias!
(if ownership is sufficiently concentrated)
Conclusions

• Three approaches to examine sustainable debt paint a bleak picture of fiscal prospects:

1. FRF structural break post-2008, deficits much larger than predicted, and larger than in previous crises

2. Capital tax DLCs peak well below required increase to offset higher debt (except if EU exploits externalities)

3. Default costs or gov. bias make debt exposed to default risk due to distributional incentives sustainable

4. Economies with concentrated debt ownership elect biased governments that sustain high debt at low spreads and default probs.