Can Deficits Finance Themselves?

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- **Result**: if fiscal adjustment is sufficiently *delayed*, then *all* financing is **self-financing**

  Split depends on nominal rigidities. All via output/tax base $\uparrow$ if rigid, all via prices $\uparrow$ if flexible.

Environment

Non-policy block

- **Aggregate demand**
  - Unit continuum of OLG households with survival probability $\omega \in (0, 1]$. Nests standard PIH model with $\omega = 1$, and mimics HANK with $\omega < 1$. Implies $\beta(1 + \bar{r}) = 1$, so $\bar{r} > 0 = g$.

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  - Optimal consumption-savings behavior yields aggregate demand relation: ▸ Details

$$c_t = \underbrace{(1-\beta\omega)}_{\text{MPC}} \times \left(\underbrace{d_t}_{\text{wealth}} + \underbrace{\mathbb{E}_t \left[\sum_{k=0}^{\infty} (\beta\omega)^k \left(y_{t+k} - t_{t+k} \right) \right]}_{\text{post-tax income}} \underbrace{-\gamma \mathbb{E}_t \left[\sum_{k=0}^{\infty} (\beta\omega)^k r_{t+k} \right]}_{\text{real rates}} \right) \quad (1)$$

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- **Aggregate supply**
  - Standard labor supply + nominal rigidities + lump-sum taxes yields NKPC ▸ Details

$$\pi_t = \kappa y_t + \beta \mathbb{E}_t \left[\pi_{t+1} \right] \quad (2)$$

Policy

- **Monetary policy**
  - Set rate on 1-period nominal bonds. Let ϕ index the cyclicality of the implied real rate:

$$\underbrace{i_t - \mathbb{E}_t\left[\pi_{t+1}\right]}_{\equiv r_t} = \phi \times y_t \tag{3}$$

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  - Taxes [lump-sum] adjust **gradually** to balance gov't budget, where τ_d parameterizes **delay**:

$$t_t = \underbrace{\tau_d \times (d_t + \varepsilon_t)}_{\text{fiscal adjustment}} + \underbrace{\tau_y y_t}_{\text{tax base financing}} - \underbrace{\varepsilon_t}_{\text{"stimulus checks"}} \tag{5}$$

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For transparent intuition look at H-rule: $\tau_{d,t} = 0$ initially, then $= 1$ after H, giving $d_{H+1} = 0$.

Equilibrium & sources of financing

- **Eq'm existence & uniqueness** Full eq'm characterization

Proposition

Suppose that $\omega < 1$ *and* $\tau_y > 0$*. The economy* (1) - (5) *has a unique bounded eq'm.*

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Suppose that $\omega < 1$ and $\tau_y > 0$. The economy (1) - (5) has a unique bounded eq'm.

- Our **Q**: how are fiscal deficits in this eq'm financed?
  - From the intertemporal gov't budget constraint:

$$\underbrace{\varepsilon_0}_{\text{deficit}} = \underbrace{\tau_d \times \left(\varepsilon_0 + \sum_{k=0}^{\infty} \beta^k \mathbb{E}_0\left(d_k\right)\right)}_{\textbf{fiscal adjustment}:\ (1-\nu)\times\varepsilon_0} + \underbrace{\overbrace{\frac{\bar{d}}{\bar{y}}\left(\pi_0 - \mathbb{E}_{-1}\left(\pi_0\right)\right)}^{p \text{ self-financing}} + \overbrace{\sum_{k=0}^{\infty} \beta^k \tau_y \mathbb{E}_0\left(y_k\right)}^{y \text{ self-financing}}}_{\textbf{self-financing}:\ \nu\times\varepsilon_0}$$

  - Next: characterize ν as a function of fiscal adjustment delay (τ_d or H)

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1. ***[Monotonicity]** It is increasing in the delay of fiscal adjustment (i.e., it is increasing in H and decreasing in τ_d).*

2. ***[Limit]** As fiscal financing is delayed more and more (i.e., as $H \to \infty$ or $\tau_d \to 0$), ν converges to 1. In words, delaying the tax hike makes it vanish.*

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Theorem

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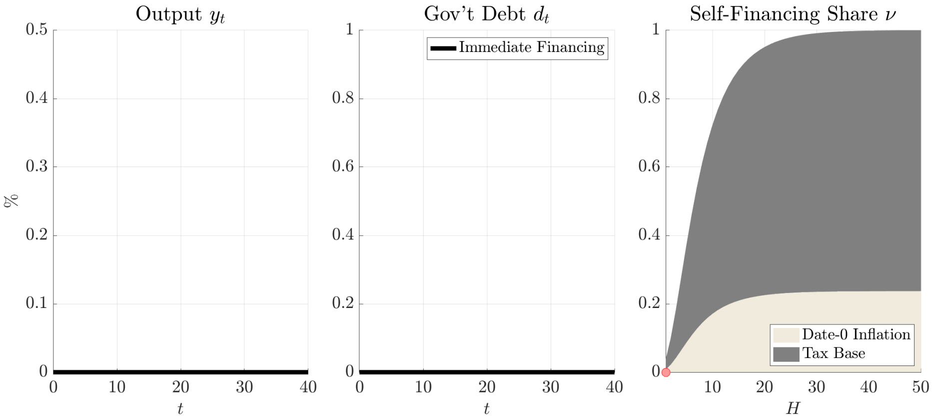
1. ***[Monotonicity]*** *It is increasing in the delay of fiscal adjustment (i.e., it is increasing in H and decreasing in τ_d).*
2. ***[Limit]*** *As fiscal financing is delayed more and more (i.e., as $H \to \infty$ or $\tau_d \to 0$), ν converges to 1. In words, delaying the tax hike makes it vanish. In this limiting eq'm:*
   a) *Gov't debt returns to steady state even without any fiscal adjustment.*
   b) *The share of self-financing coming from the tax base expansion is increasing in the strength of nominal rigidities. With rigid prices the cumulative output multiplier is $\frac{1}{\tau_y}$.*

A graphical illustration



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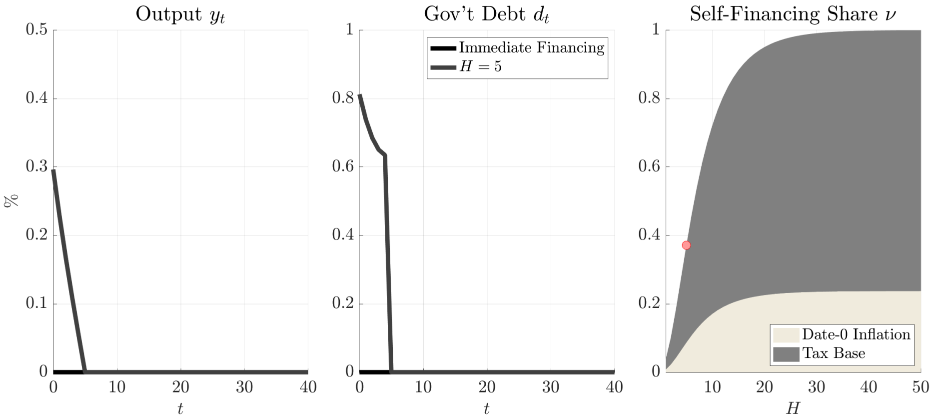

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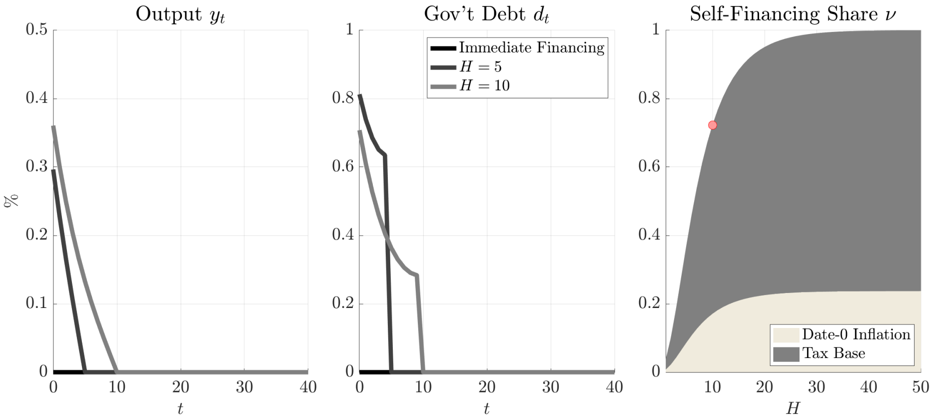

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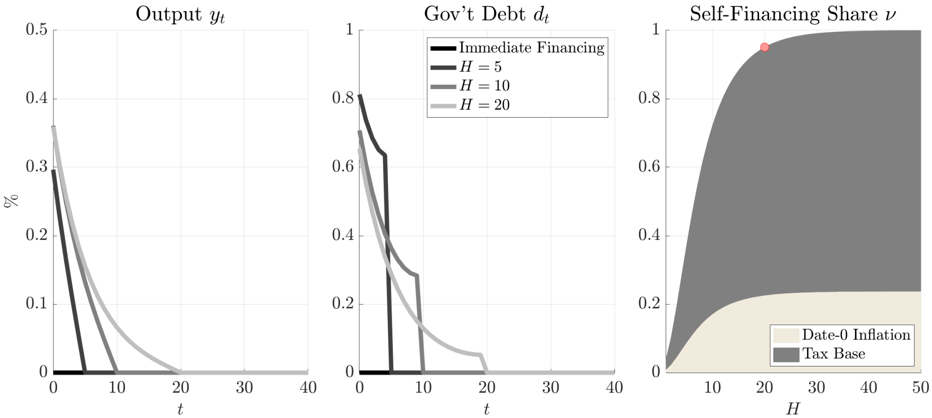

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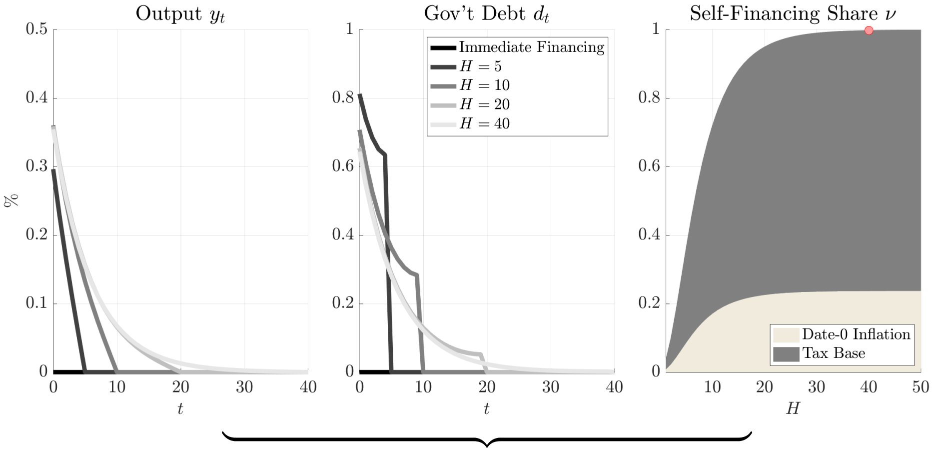

if **fiscal adjustment** is delayed, then financing will come via eq'm **prices & quantities**

Economic intuition

- Background: self-financing in a **"static" Keynesian cross** w/ our tax base channel
  - Transfer at $t = 0$, tax (if needed) at $t = 1$, assume static KC at $t = 0$.

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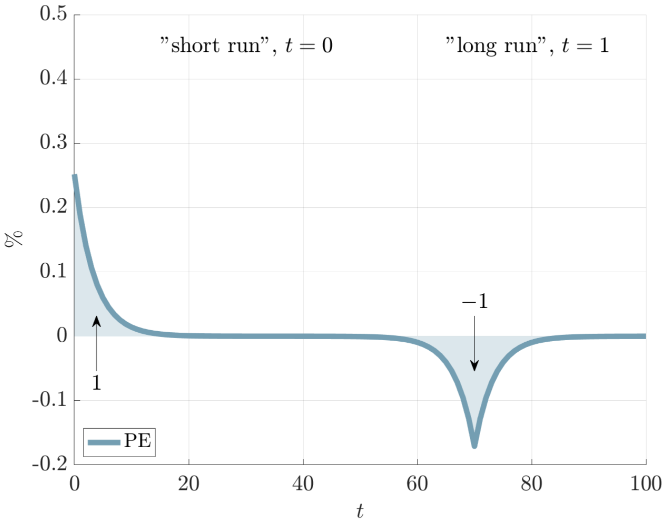

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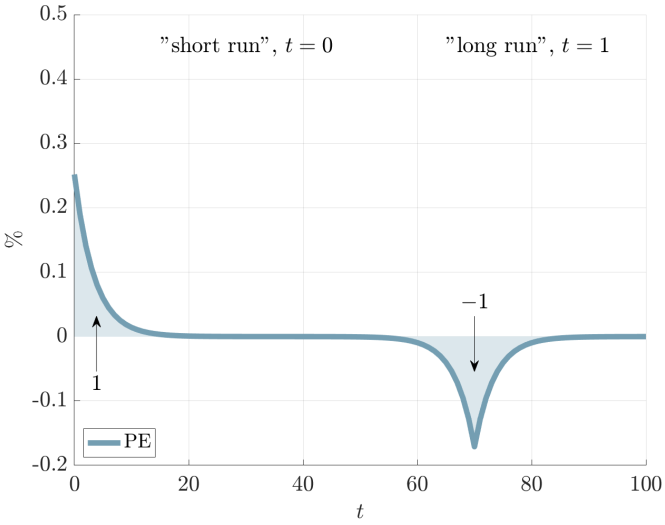

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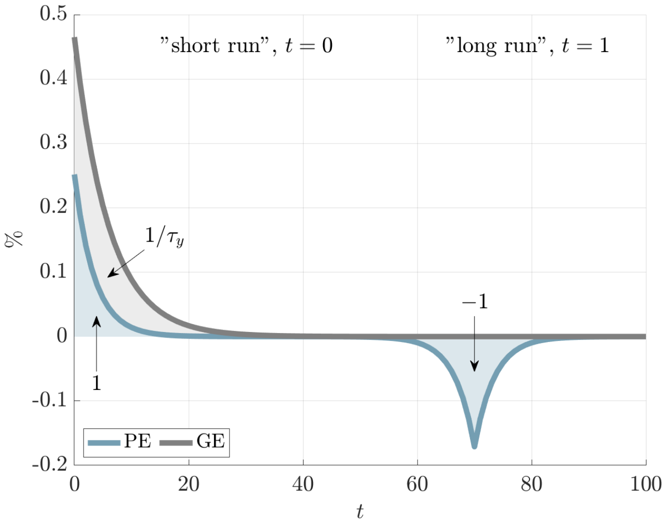

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With imperfectly rigid prices: boom partially leaks into **prices** instead of **quantities**.

Practical Relevance

Extensions & generality

1. **Policy** ▸ Details

   ◦ Fiscal policy: distortionary taxes, gov't purchases

   ◦ **Monetary response**

     → Intuition: $\phi < 0$ accelerates the Keynesian cross, $\phi > 0$ delays it

     → Length of eq'm boom is increasing in ϕ. Full self-financing feasible if $\phi < \bar{\phi}$, where $\bar{\phi} > 0$. More generally: increasing borrowing costs limit room for self-financing.

2. **Economic environment** ▸ Details

   ◦ Rest of the economy: open economy ($\nu \downarrow$!), different NKPC, wage rigidity, investment

   ◦ **Demand relation**

     → Need discounting—break Ricardian equivalence + front-load spending.

     → Same result (numerically) in HANK. Why? OLG AD f'n $\approx$ HANK AD f'n. [Wolf (2023)]

Self-financing in the quantitative model

Environment: match evidence on dynamic (tail) MPCs + speed of fiscal adjustment

Rest of model: flat NKPC + acyclical real rate, consistent with pre-covid empirical evidence.

▸ Details, extensions, & alternative calibration strategies

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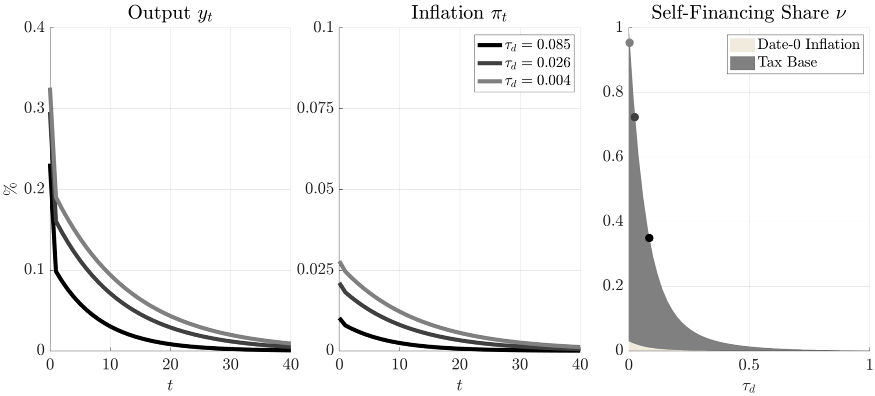

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- **Implications**
  a) **Theory**: grounded in classical failure of Ricardian equivalence + emphasize y vs. p
     vs. FTPL: no discontinuity in adjustment horizon. Delayed adjustment = never adjust. ▸ Details
  b) **Practice**: self-sustaining stimulus may be less implausible than commonly believed
     In particular if supply constraints are slack—get self-financing via protracted output boom.

Thank you!

Appendix

Aggregate demand

- **Consumption-savings problem**
  - OLG hh's with survival probability $\omega \in (0,1]$ [can interpret as $\approx$ 1 - prob. of liq. constraint]

$$\mathbb{E}_t \left[\sum_{k=0}^{\infty} (\beta\omega)^k \left[u(C_{i,t+k}) - v(L_{i,t+k}) \right] \right]$$

  - Invest in actuarially fair annuities. Budget constraint:

$$A_{i,t+1} = \underbrace{\frac{I_t}{\omega}}_{\text{annuity}} \left(A_{i,t} + P_t \cdot \left(\underbrace{W_t L_{i,t} + Q_{i,t}}_{Y_{i,t}} - C_{i,t} - T_{i,t} + \text{transfer to newborns} \right) \right)$$

- **Aggregate demand relation**

$$c_t = \underbrace{(1-\beta\omega)}_{\text{MPC}} \times \left(\underbrace{d_t}_{\text{wealth}} + \underbrace{\mathbb{E}_t \left[\sum_{k=0}^{\infty} (\beta\omega)^k (y_{t+k} - t_{t+k}) \right]}_{\text{post-tax income}} \underbrace{- \gamma \mathbb{E}_t \left[\sum_{k=0}^{\infty} (\beta\omega)^k r_{t+k} \right]}_{\text{real rates}} \right) \qquad (6)$$

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back

Aggregate supply

- **Unions** equalize post-tax wage and average consumption-labor MRS. This gives

$$(1-\tau_y)W_t = \frac{\chi \int_0^1 L_{i,t}^{\frac{1}{\varphi}} di}{\int_0^1 C_{i,t}^{-1/\sigma} di}$$

  Log-linearizing:

$$\frac{1}{\varphi}\ell_t = w_t - \frac{1}{\sigma}c_t$$

- Combining with optimal firm pricing decisions we get the **NKPC**:

$$\pi_t = \kappa y_t + \beta \mathbb{E}_t\left[\pi_{t+1}\right]$$

  - Note: no time-varying wedge since distortionary taxes τ_y are fixed

▸ back

Equilibrium characterization

- First step to eq'm characterization is a more concise representation of agg. demand
- Combining (1), (3), (4), (5), and output market-clearing, we get

$$y_t = \mathcal{F}_1 \cdot (d_t + \varepsilon_t) + \mathcal{F}_2 \cdot \mathbb{E}_t \left[\sum_{k=0}^{\infty} (\beta\omega)^k \, y_{t+k} \right] \tag{7}$$

  - Here: $\mathcal{F}_1 \equiv \frac{(1-\beta\omega)(1-\omega)(1-\tau_d)}{1-\omega(1-\tau_d)}$ and $\mathcal{F}_2 = (1-\beta\omega)\left(1 - \frac{(1-\omega)\tau_y}{1-\omega(1-\tau_d)}\right)$
  - Note: $\mathcal{F}_1 = 0$ if $\omega = 1$—reflects lack of direct effect of deficit on consumer spending/ aggregate demand under Ricardian equivalence

- Equilibrium: (2), (7) and law of motion for government debt

▸ back

Equilibrium characterization

- We will look for **bounded equilibria** in the sense of Blanchard-Kahn
  - Note: in our case—with $\omega < 1$ and $\tau_y > 0$—this is enough to rule out sunspot solutions. Recover same eq'm through limit $\phi \to 0^+$.
- The unique bounded eq'm takes a particularly simple form:

$$y_t = \chi(d_t + \varepsilon_t), \quad \mathbb{E}_t\left[d_{t+1}\right] = \rho_d(d_t + \varepsilon_t)$$

where $\chi > 0$ (deficits trigger boom) and $0 < \rho_d < 1$ (debt goes back to steady state).

back

Relation to classical FTPL

Only difference in non-policy block is **non-PIH consumers**. How does that change things?

- Key implication: can get **“self-financing”** with *conventional* policy mix
  - Recall: fiscal policy is “Ricardian” in the usual sense + Taylor principle is satisfied
  - This takes care of some of the literature’s **conceptual concerns** with the classical FTPL:
    a) No need for fiscal authority to *never* adjust. A *finite* delay is enough.
    b) Not vulnerable to behavioral frictions that complicate coordination [Angeletos-Lian]
- Secondary insight: focus attention away from **prices** and on **tax base channel**
  Robust insight is that eq’m outcomes adjust to finance the deficit—not whether it’s prices or quantities.

back

Distortionary fiscal financing

- **Environment**
  - **Fiscal adjustment** now instead through distortionary tax adjustments. Specifically:

$$\tau_{y,t} = \tau_y + \tau_{d,t}(D_t - D^{ss})$$

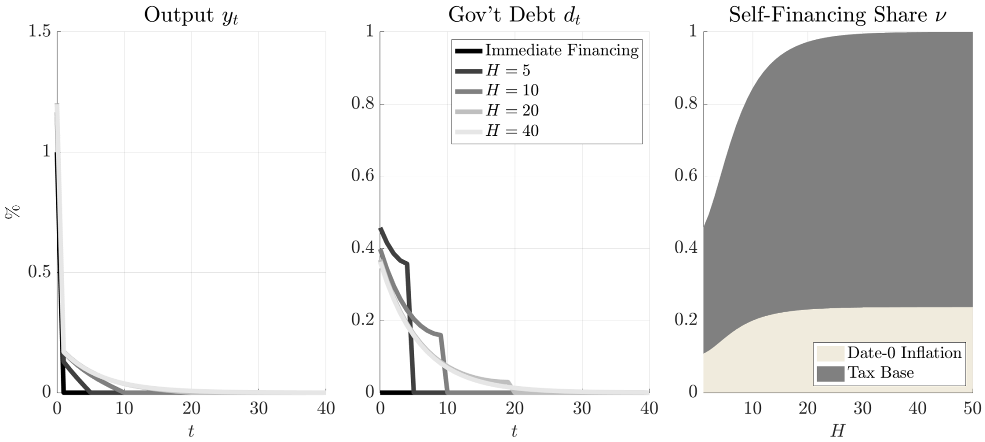
  - Only effect is to change (2) to

$$\pi_t = \kappa y_t + \beta \mathbb{E}_t [\pi_{t+1}] + \zeta_t d_t$$

- **Self-financing result**
  - Easy to see: exactly the same limiting self-financing eq'm as before
  - Why? tax adjustment not necessary, so distortionary vs non-distortionary is irrelevant

back

Government purchases



back

Monetary policy reaction

- **Intuition**: $\phi < 0$ accelerates the Keynesian cross, $\phi > 0$ delays it

Proposition

There exists a $\bar{\phi} > 0$ such that:

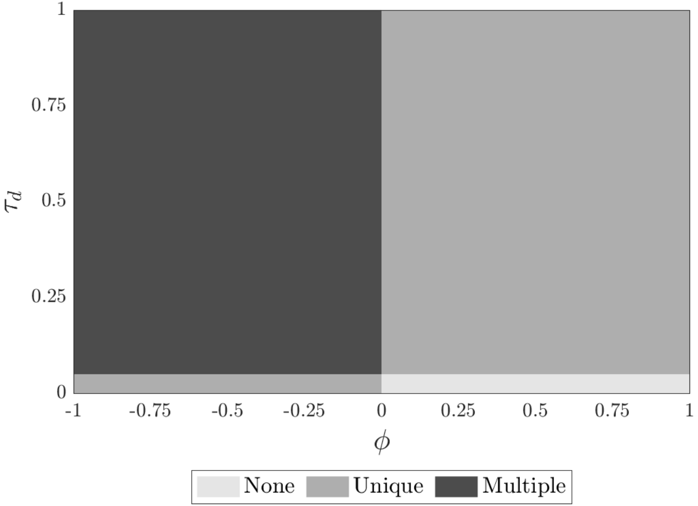
1. *An equilibrium with full self-financing exists if and only if $\phi < \bar{\phi}$.*
2. *The persistence of $\rho_d(\phi)$ of gov't debt (and output) in the equilibrium with full self-financing is increasing in ϕ, with $\rho_d(0) \in (0, 1)$ and $\rho_d(\bar{\phi}) = 1$.*

Note: same logic for standard Taylor-type rules like $i_t = \phi \times \pi_t$.

- What happens if $\phi > \bar{\phi}$? Depends on **fiscal adjustment**:
  - If too delayed then no bounded eq'm exists. For such an aggressive monetary policy fiscal adjustment needs to be *fast enough*.
  - If adjustment is fast enough then there is **partial** but not **complete self-financing**.

back

Leeper regions



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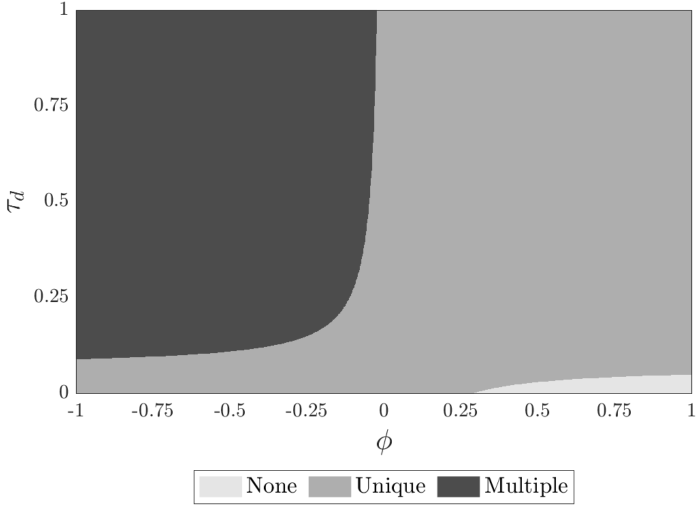

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A generalized aggregate demand relation

- **Important**: our results are *not* tied to the particular **OLG** microfoundations
- Instead: it's all about two empirically plausible features of **consumer demand**
  1. *Discounting*: households at date $t = 0$ respond little to expectations of far-ahead tax hikes
  2. *Front-loaded spending*: transfer receipt (and higher-order GE income) is spent quickly

in **OLG** both of these are ensured by $\omega < 1$

- Will formalize this using the following **generalized AD relation**:

$$c_t = M_d d_t + M_y \left(y_t - t_t + \delta \mathbb{E}_t \left[\sum_{k=0}^{\infty} (\beta\omega)^k (y_{t+k} - t_{t+k}) \right] \right)$$

Rich enough to nest PIH, OLG, spender-saver, spender-OLG, behavioral discounting, ... Also can provide very close reduced-form fit to consumer behavior in quantitative HANK models.

back

A generalized aggregate demand relation

- **Headline result**: sufficient conditions for **self-financing**

  A1 **Discounting**

  $$\omega < 1$$

  Transfer today and taxes in the future redistribute from future generations to the present.

  A2 **Front-loading**

  $$M_d + \frac{1-\beta}{\tau_y}(1-\tau_y)M_y\left(1+\delta\frac{\beta\omega}{1-\beta\omega}\right) > \frac{1-\beta}{\tau_y}$$

  Self-financing boom is front-loaded enough to deliver $\rho_d < 1$.

- Note: the self-financing result *fails* if there are **PIH households**

  "Deep-pocket" rational investor intuition—infinitely elastic PIH hh's link infinite future & present.

back

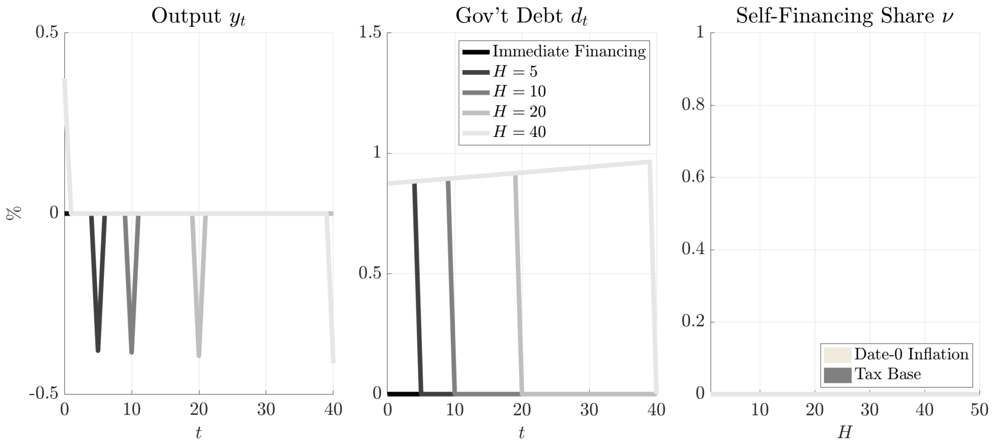
Adding permanent-income consumers

- Adding a margin of **PIH consumers** connects the present with the (infinite) future
  - Implication: policy at H invariably affects short-run, for any H. No more separation.
  - With our baseline policy ($\phi = 0$, uniform taxes): invariably get $\nu = 0$, since otherwise PIH consumption would be permanently away from steady state
- Is this a practically relevant consideration? **Not really**:
  1. Result driven by extreme feature of PIH model: ***infinite* elasticity of hh asset demand**
     - In multi-type OLG model: self-financing th'm applies iff interest rate elasticity is finite
     - Quantitative analysis [incl. HANK]: finite elasticity, obtain self-financing
  2. **Other policy mixes** at H deliver smoothness of ν in PIH share
     - Alternatives at H: MP stabilizes the bust around H, or date-H taxes only on PIH consumers
     - Then ν is continuous in PIH share θ: $\nu \to \frac{\tau_y(1-\theta)}{1-(1-\tau_y)(1-\theta)} < 1$

back

The importance of discounting

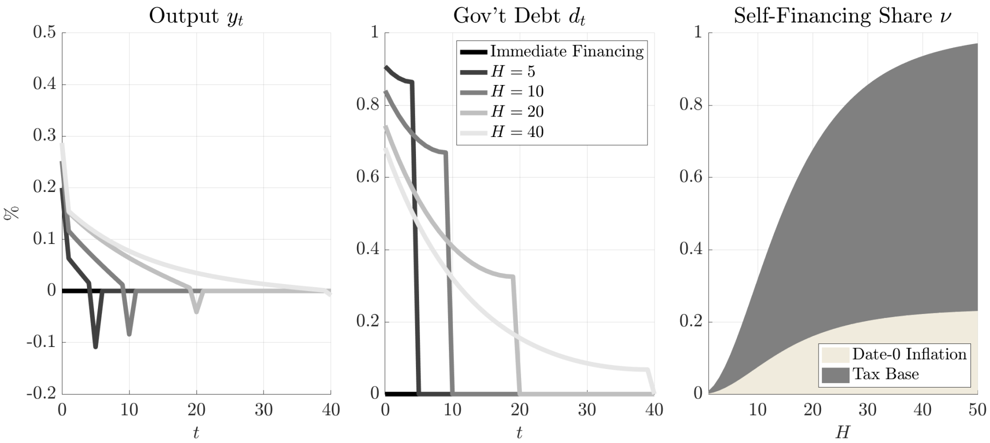
spender-saver model



▸ back

The importance of discounting

hybrid spender-OLG model



▸ back

Adding investment

- **Environment**
  - **Households**: receive labor income plus dividends e_t. Pay taxes τ_y on both.
  - **Production**: standard DSGE production block. Key twist: no tax payments anywhere.
- **Self-financing result**
  - For rigid prices exactly the same self-financing eq'm as before. Why? Keynesian cross & gov't budget both have c_t rather than y_t in them, so same pair of equations as before
  - Partially sticky prices: more complicated mapping from $\{c_t\}_{t=0}^{\infty}$ back to π_0, so fixed point is more complicated, but can still show that self-financing eq'm exists
    Perfectly analogous to change in NKPC. Just change mapping into π_0.

back

Open economy

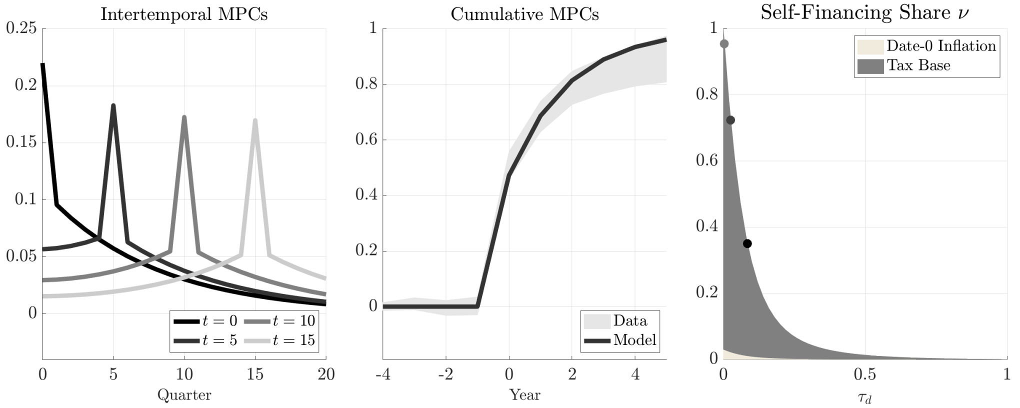
- **Environment**
  - N countries (all = baseline economy)
    - Each country produces a single good, and consumes both the domestic and foreign goods
    - For simplicity: fixed real rates and prices, so fixed exchange rates. Gives simple international Intertemporal Keynesian Cross.
  - Policy experiment: fiscal stimulus in country i
- **Self-financing result**
  - If H is finite for all countries $-i$, then $\nu_i \to 1$ as $H \to \infty$
    Same conclusion for $\tau_{d,-i} > 0$ and $\tau_{d,i} \to 0$.
  - Quantitative: convergence to full self-financing (much) delayed due to leakage abroad

back

Alternative calibration strategies

Baseline: match impact and short-run MPCs, then extrapolate

Note: also consistent with evidence on long-run elasticity of asset supply.

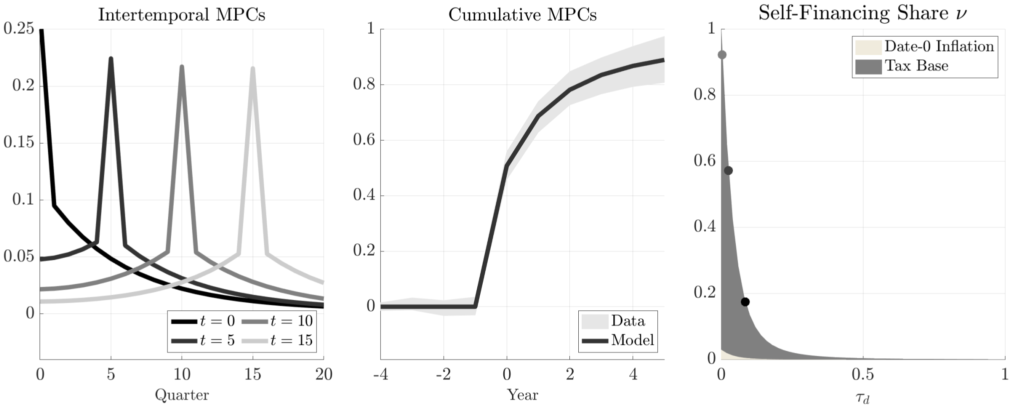


back

Alternative calibration strategies

Extension: two-type OLG + spender model to match cumulative MPC time profile

This gives $\omega_2 = 0.97$, and thus counterfactually elastic asset supply ($\approx 7x$ emp. upper bound).

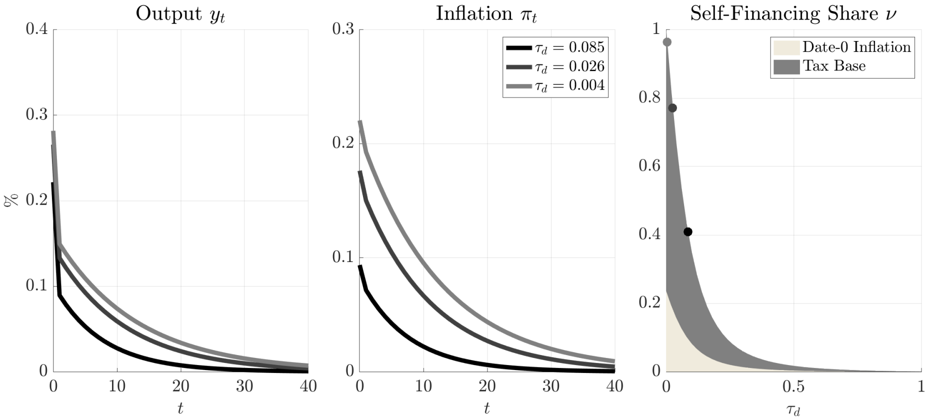


▸ back

More flexible prices

Steeper NKPC: arguably more informative about post-covid episode

Takeaways: (i) change ν_y/ν_p split & (ii) faster convergence to self-financing limit

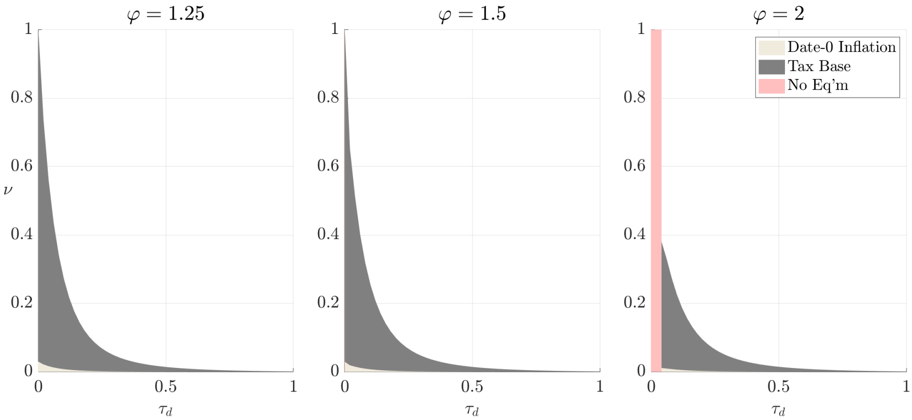


back

Active monetary policy reaction

Monetary response: consider standard Taylor rule $i_t = \phi \times \pi_t$

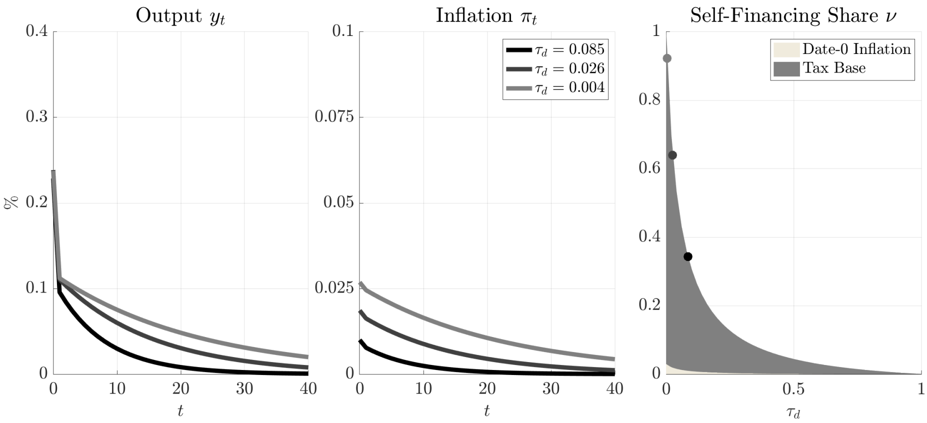
Takeaways: (i) slower convergence & (ii) no self-financing eq'm exists for sufficiently large ϕ



back

Other models

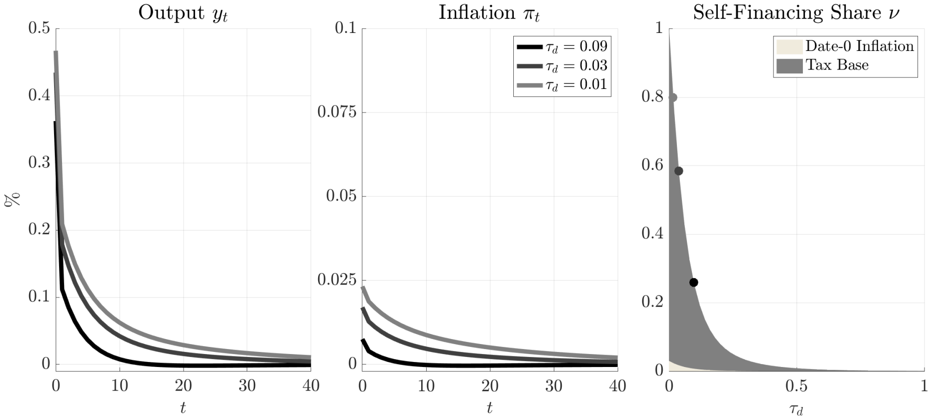
Environment: baseline + behavioral friction [strong cognitive discounting]



back

Other models

Environment: HANK model [similar to Wolf (2023)]



▸ back