

DYNAMIC ADJUSTMENT OF FISCAL POLICY UNDER A DEBT CRISIS

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In an overlapping generations framework that allows for the presence of a debt crisis scenario (debt bubbles), we introduce productive government expenditures, and endogenous deficits through a dynamic fiscal rule that combines fiscal stimulus and fiscal consolidation. We formally argue that a fiscal rule must be pro-cyclical to output for government investment financing and simultaneously has to control for the level of debt adjusting taxation for a policy aiming to escape a situation of exploding debt and low economic activity. Then, when the economy becomes sustainable (or in an economy's high initial private capital), the same rule, has to endogenously adapt to the actual level of debt and income in order to stimulate private investment through lower taxes. We provide a numerical example for our theoretical results and show that in economies with sufficiently low levels of capital and high levels of debt, the tax rate has to adjust non-monotonically during the recover process, reflecting the two counter-balancing properties of the examined fiscal policy rule. However, under a threshold level of initial capital stock, taxes must adjust monotonically (negatively) to boost private investment activity, and in turn, alleviating the volume of debt through a higher tax base.

Keywords: Fiscal sustainability, Fiscal rules, Bond-financed deficits

JEL classification: E6, H6, H30

The full working paper can be found [here](#).