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The effect of public debt on growth and welfare under the golden rule of public finance

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Abstract

This study analyzes an endogenous growth model with public capital and public debt under the “golden rule of public finance” which prohibits the government from issuing bonds for nonproductive purposes. We assume that public investment is fully financed by fiscal deficit in our model analyzing the effects of public debt on the economy. Our results under the fiscal rule can be summarized as follows. First, the model shows two steady states exist: one is unstable with zero growth and the other is saddle-path stable with positive growth. The economy may not converge to the stable steady state if the public capital relative to public debt is not sufficient at the initial point. Second, the model shows that the growth maximizing tax rate exceeds the welfare-maximizing tax rate in considering transitional dynamics, but the short-term effect can differ from that of a model with a balanced budget rule.

Keywords: Endogenous growth; Golden rule of public finance; Public investment; Welfare

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