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Fiscal policy, debt constraint and expectations-driven volatility*

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Abstract

Imposing some constraints on public debt is often justified regarding sustainability and stability issues. This is especially the case when the ratio of public debt over GDP is restricted to be constant. Using a Ramsey model, we show that such a constraint can however be a fundamental source of indeterminacy, and therefore, of expectations-driven fluctuations. Indeed, through the intertemporal budget constraint of the government, income taxation negatively depends on future debt, i.e. on the expected level of production. This mechanism ensures that expectations on the future tax rate may be self-fulfilling. We show that this is promoted by a larger ratio of debt over GDP.

JEL classification: E32, H20, H68.

Keywords: Indeterminacy, endogenous cycles, public debt, income taxation.

1 Introduction

To dampen the effects of the last financial crisis, many countries have engaged in expansionist fiscal policies. Such policies have been carried out even in countries that already experienced large levels of public debt. This partly explains the sovereign debt crisis that followed. To decrease the associated insolvency risk of public debt, there is now an increasing consensus to promote fiscal policies that fulfill some constraints on public debt. In accordance for instance with the Maastricht treaty, the rule stipulating that the ratio of public debt over GDP has to be less than a maximal value is often advocated to promote sustainability and stability.

Assuming that this constraint is binding, as now in the US and most European countries, we show that imposing such a rule can however be a source

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