A Theory of Fiscal Responsibility and Irresponsibility

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We propose a political economy mechanism that explains the presence of fiscal regimes punctuated by crisis periods. Our model focuses on the interaction between successive deficit-biased governments subject to i.i.d. fiscal shocks. We show that the economy transitions between a fiscally responsible regime and a fiscally irresponsible regime, with transitions occurring during crises when fiscal needs are large. Under fiscal responsibility, governments limit their spending to avoid transitioning to fiscal irresponsibility. Under fiscal irresponsibility, governments spend excessively and precipitate crises that lead to the reinstatement of fiscal responsibility. Regime transitions can only occur if governments' deficit bias is large enough.

**Url:**<https://www.nber.org/papers/w30601>