Discussion of

Political Economy of Sovereign Debt: A Theory of Cycles of Populism and Austerity

by Dovis, Golosov, and Shourideh

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IMF

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The *want* operator

Model delivers

- Cyclical behavior
- "Populist" phase: low inequality, external borrowing
- "Austerity" phase: high inequality, debt deleveraging

What to like

- Elegant theory
- Overshooting component — rare with fully rational, optimizing agents
- Makes sense of seemingly inefficient behavior

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How it works

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Ingredients

- Productivity types + labor income taxes + endogenous labor supply
  - … Tax revenues lower earnings inequality but depress output
  - … Efficiency / equity tradeoff
- Sovereign borrowing + no shocks and/or complete markets
  - … Can borrow to finance transfers
  - … Can default ex-post: risk-free subject to debt limit
  - … Time inconsistency: debt limit is endogenous
- Overlapping generations + financial income taxes + save in government bonds
  - … Can tax old people's savings (aka domestic default): reduce inequality with no distortion
  - … Domestic debt + transfers reduces consumption inequality when income inequality is high
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The key: two interacting sources of time inconsistency

- All choices subject to sustainability constraint

$$H(Y) \leq \frac{\hat{\beta}}{\beta}\left(W(B') - \underline{W}\right)$$

- When constraint binds
  - To sustain more debt issuance
    ... Need to provide incentives to repay tomorrow — Decrease $H(Y)$ and Y
  - To sustain more output
    ... Need to tolerate more inequality tomorrow — Increase $W(B')$, decrease B'

- Key: *tradeoff* is time-inconsistent

	Benefits	Costs
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Inequality	t	t and $t+1$

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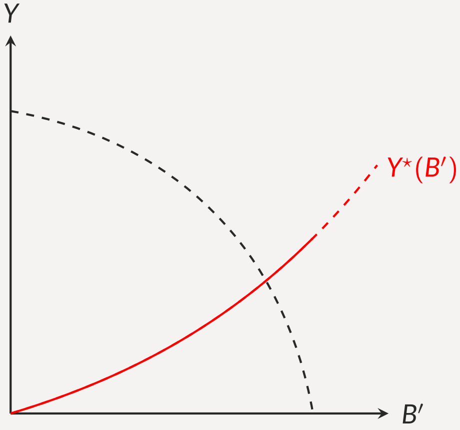

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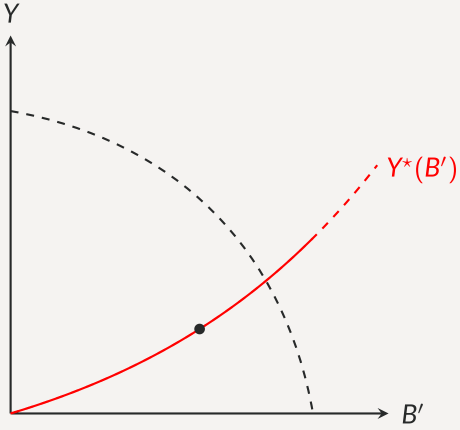

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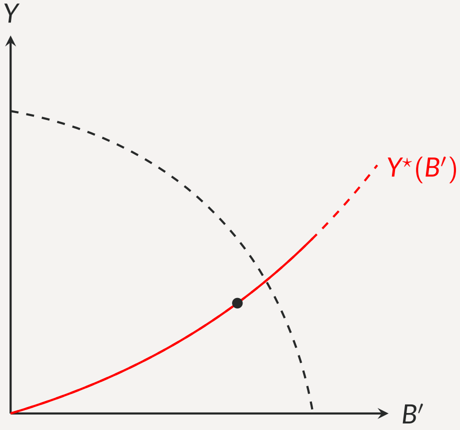

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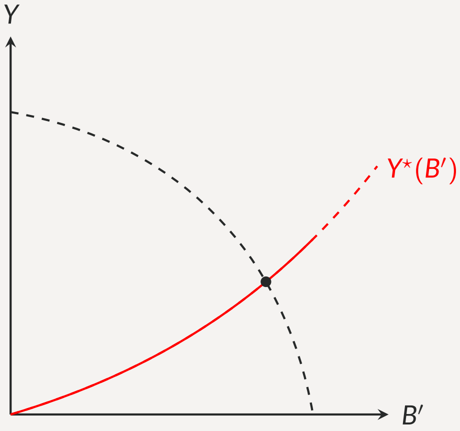

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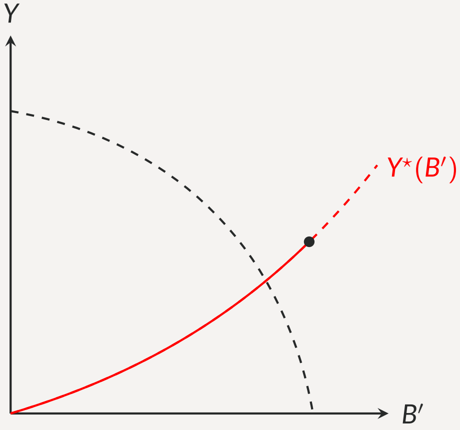

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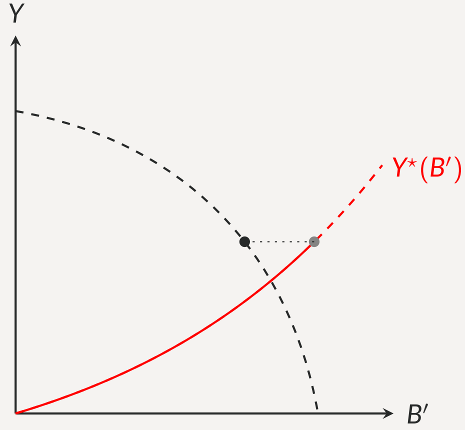

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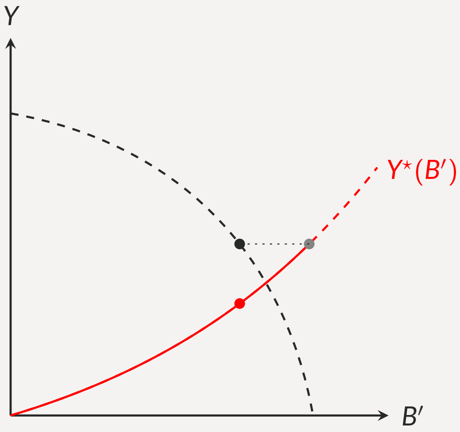

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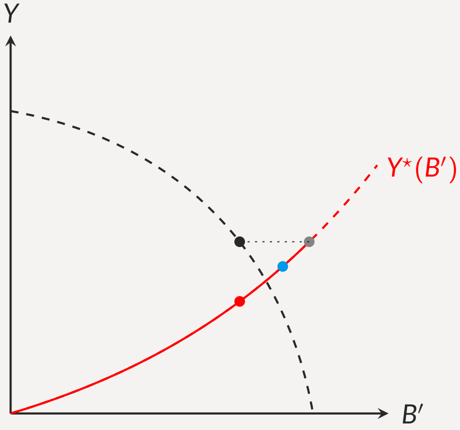

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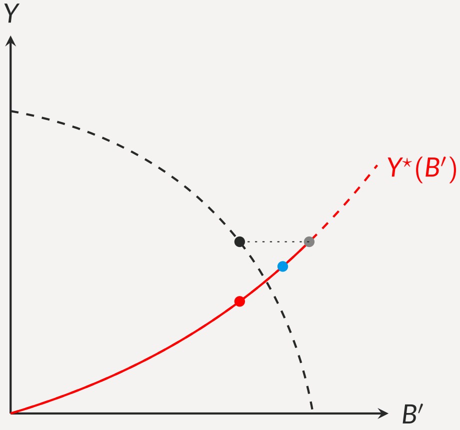

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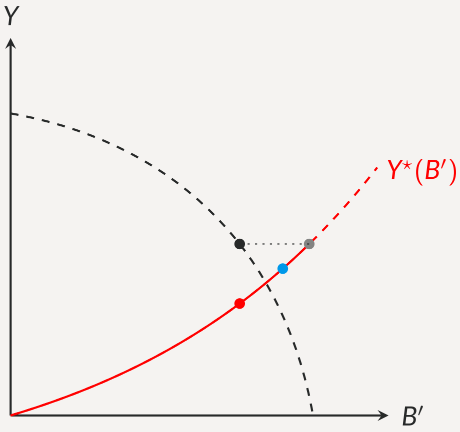

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Two Comparisons

Phelan and Stacchetti (2001)

- Similar model with
  - Endogenous labor supply
  - Savings
  - Time-inconsistent taxes

- Time inconsistency: capital accumulation
  - Want tax capital ex-post, promise low taxes ex-ante

- No cycles? — Example with $k_0 > k^\star$ overshoots initial capital reduction
  - Only link between t and $t+1$ is the capital stock
  - To induce savings, can subsidize labor today or 'promise' low taxes

    … Same result

Stop & Go Dynamics

- Phenomenon also studied by Latin American structuralists
  - … Díaz-Alejandro, Ferrer, Braun and Joy, etc…
  - … More about shocks/imperfect planning than purposeful overshooting

- Also two phases (but with different names)

- Testable differences:
  - Growth in 'Go' phase *v.* low labor and output in 'populist' phase
  - REER depreciation in 'Stop' phase *v.* high after-tax wages in 'austerity'?

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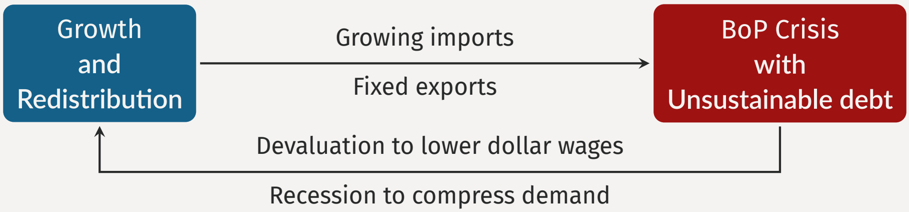

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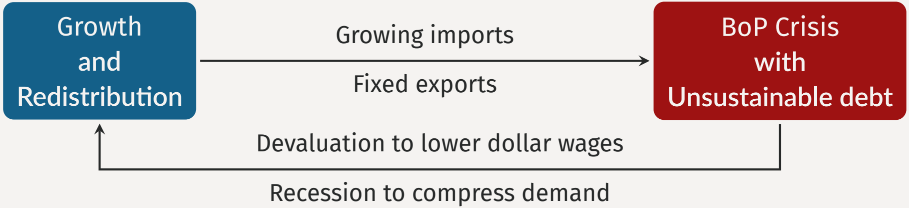

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Concluding Remarks

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  - … All assumptions needed, sharp characterization, basic idea applies to many setups
- Last comments
  - … Quantitative performance?
    - … Baseline is a little underwhelming
    - … Three-period model seems to have larger effects
    - … Would a full life-cycle give more traction?
  - … How to think about best SPE?
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