Discussion:
Can Deficits Finance Themselves?
by Angeletos, Lian, and Wolf

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Background

- Lot's of research on fiscal multipliers after 2008/9 Great Recession

- Most of this literature abstracts from the details of financing,
  i.e. assumes Ricardian equivalence

- "New Keynesian versus old Keynesian government spending multipliers" by Cogan, Cwik, Taylor, Wieland

Background

- New workhorse business cycle model (HANK) breaks Ricardian equivalence
  - Focus on response of consumption: Auclert et al (2018), Mitman et al (2019), ...
  - Focus on response of investment: Bayer et al (2022), ...
  - Focus on response of taxes: Ferriere et al (2022), ...

- Timing of financing not well explored

- Generally, few analytical results in this environment

This paper: Focus on timing of fiscal adjustment

- **Research Question**: Do fiscal deficits finance themselves (inflation vs income)?

- **Assumptions**: Non-Ricardian + Demand-driven + Linear environment

- **Findings**:
  - 1. Deficits are self-financing when adjustment is indefinitely postponed

  - 2. Adjustment of income (tax-base) does most of the self-financing

Comment 1: Free deficits or not?

- When does the inflation response kick in?

- Key issue for practical relevance of deficits financing

- Recent US experience suggest no free lunch

# Comment 1: Free deficits or not?
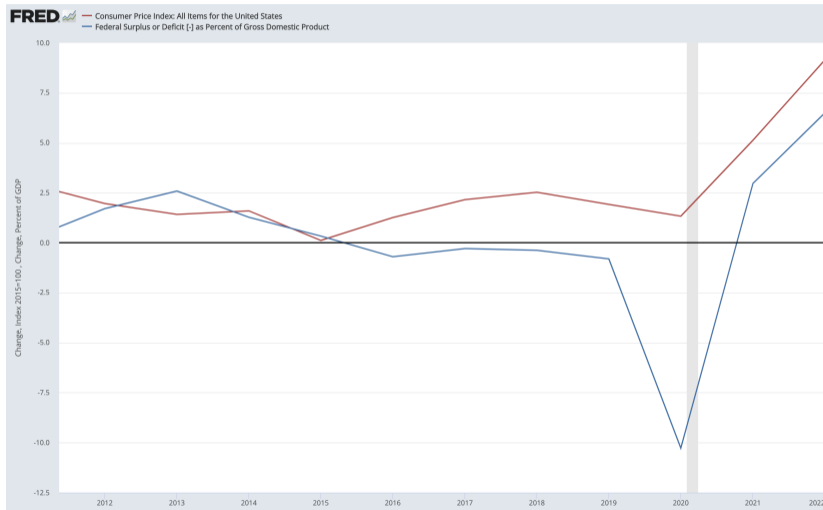
Comment 1: Free deficits or not?

- Explore the state-dependency of the output-inflation mix:
  - Non-linear Phillips curve
  - Endogenous liquidity trap
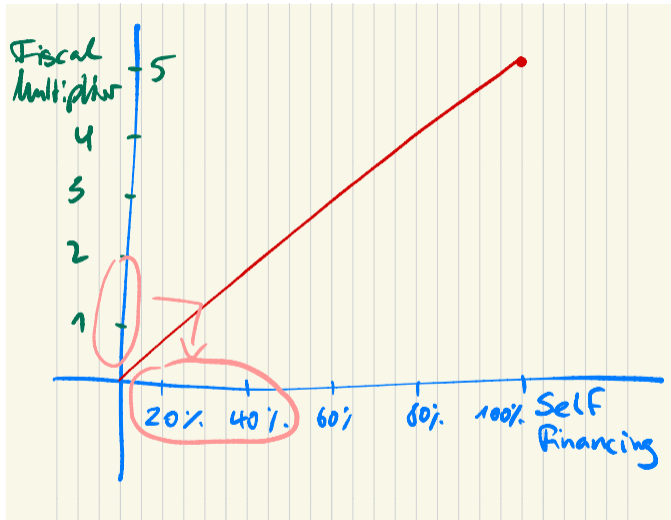 - Default

- Requires non-linear solution methods
  - Tractable OLG models
  - Tractable income risk models
  - Sovereign default models

- Can you map the self-financing into a multiplier diagram (also for the dynamic model)?

Comment 3: Interest rate response
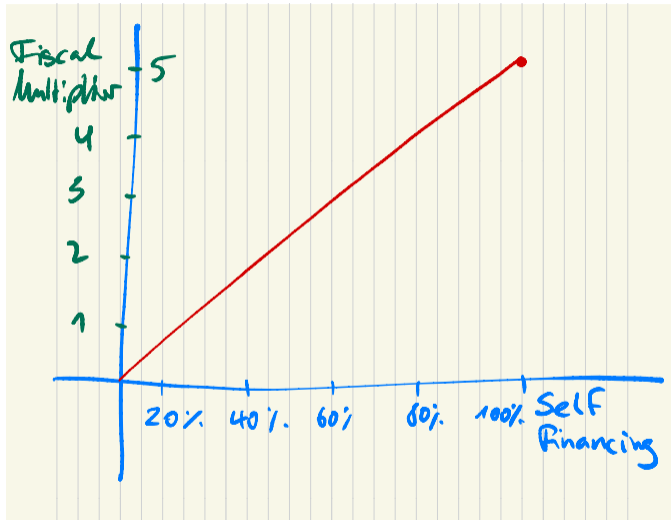
Equilibrium in the bond market:

$$\underbrace{\frac{B_t}{\pi_t}}_{\text{Supply}} = \underbrace{\int b(w_t, r_t) d\mu_t}_{\text{Demand}}$$

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- Real rate increases with persistent/permanent deficits (see Bayer et al, 2022)

- Monetary policy understands this and increases real rate accordingly
  - Cost of deficits increase
  - No self-financing case becomes more likely

Comment 4: Side-effects of inflation

Household Income:

- Theoretical and empirical support for sticky wages
  (e.g. Schmitt-Grohe&Uribe (2016), Auclert et al (2021), Broer et al (2021))
- Inflation erodes real income

Household Wealth:

- Inflation redistributes from old bond-holders to young mortgage-holders

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$$COV(\pi, MPC) \quad \lessgtr \quad 0$$

Minor comments

- How important are non-indexed tax brackets?

- How important is the incidence of taxes, i.e. $COV(\beta, \tau)$?

- How would wealth effect in labor supply affect results?

- How important is the liquidity channel of government debt?

Conclusion:

This paper: Timing of deficits is important

- Self-financing becomes more likely when fiscal adjustment is postponed
- Clean analytical results and some quantitative exploration
- Important benchmark for the study of fiscal policy

Open questions:

- Quantitative exploration of inflation vs income adjustment
- Empirical evidence (elasticity of multiplier wrt to postponing fiscal adj)