Fiscal Crisis Resolution: Taxation versus Inflation

Michael Kumhof
Stanford University

May 2004

Summary

This paper presents a model of fiscal and monetary policy that evaluates the tradeoff between higher distortionary labor taxation and higher inflation in the resolution of fiscal crises. Fiscal crises arise because of exogenous fiscal transfer spending shocks. Government debt is domestically held and nominal.

Data are presented to show that such debt is now at least as important as external government debt in many key emerging markets, and that it is a very important item on the balance sheets of domestic financial intermediaries, despite the gradual disappearance of financial repression. An important reason is that government debt helps to alleviate informational asymmetries, especially in less developed financial markets. In the model, government debt therefore enters the economy's intermediation technology. The key contribution of this mechanism is that it makes unanticipated inflation costly. Price level determination then becomes the result of an explicit government optimization problem over a tax distortion and an inflation distortion. Higher taxes have a distortionary effect on labor supply, but also a beneficial effect by lowering inflation and supporting a higher public debt stock that in turn supports intermediation and the capital stock.

In such a model, first period price level jumps generally do not contribute to the resolution of fiscal crises. Instead, ongoing but modest inflation is used to levy seigniorage on debt. This gives rise to a fiscal theory of inflation in which the transmission mechanism does not rely on base money seigniorage. It is found that a large contribution of inflation to the resolution of a fiscal crisis is only optimal when the fiscal shock is transitory, while a long-lived shock is optimally financed mostly through taxes.