Policy brief

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International Growth Centre

The Political Economy of Sovereign Debt Overhang

In brief

- Economic intuition would state that a capital-poor country can benefit from importing financial capital. Yet, countries that tend to accumulate foreign liabilities tend to stagnate, while fast-growing economies provide capital to the rest of the world. This research attempts to provide build an economic framework to understand the above phenomenon and provide recommendations for fiscal policy in developing open economies, focusing on the relationship between debt, taxation and growth.

- **Key policy implications:**
  - **Sovereign debt deters investment** - governments with large outstanding debt positions have an incentive to tax capital income after an investment in place. Thus, investors avoid making large commitments in high-debt environments.
  - **Reducing sovereign debt is facilitated by political stability** - polarized political systems find it difficult to reduce debt and encourage growth.
  - **If an economy wishes to borrow, the fiscal authority should run surpluses** - although counter-intuitive, sovereign debt leads to distortionary taxation when the debt is due.

- Countries with relatively high growth rates have grown while paying down sovereign debt and/or accumulating international reserves. However, this is not a result of business cycle fluctuations or differences in initial debt positions.

- **Action points**: prolonged growth is facilitated by reducing sovereign debt and accumulating foreign reserves; a low debt-level opens the way for a secure environment for capital income and low rates of capital taxation; create a fiscal framework where incumbents do not face an incentive for over-spending; governments should enforce private debt contract to the extent possible if citizens need to borrow.

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Policy Motivation

"Countries that accumulate foreign liabilities tend to stagnate, while fast-growing economies provide capital to the rest of the world"

Developing economies have heterogeneous experiences with growth and openness. Our research addresses why this may be so. The research documents a core empirical fact: The countries that grow relatively fast do so while reducing sovereign liabilities and accumulating foreign reserves. Standard economic intuition states that a capital-poor country can benefit from openness by importing financial capital. However, in practice, countries that accumulate foreign liabilities tend to stagnate, while fast-growing economies provide capital to the rest of the world. This project builds an economic framework to understand this phenomenon and provide policy guidance.

Policy Impact

The primary goal of the research project is to provide recommendations for fiscal policy in developing open economies. It is particularly focused on the relationship between debt, taxation, and growth. Specifically, the research focuses on the correct management of public debt and the timing of taxes – when should the government fund current fiscal expenditures from tax revenues and when should it issue new debt.

Audience

The audience for this research includes policy makers in developing economies, particularly those involved in fiscal policy or managing international capital flows. The research has specific recommendations for taxing financial inflows from abroad as well as the issuance and repayment of sovereign debt. The ministry of finance typically handles such decisions.

Policy Implications

"Polarized political systems find it difficult to reduce debt positions and encourage growth"

Sovereign debt deters investment

The distinguishing feature of investment is that costs precede returns. This exposes the investment to taxation and expropriation. Governments with large outstanding debt positions have an incentive to tax capital income after an investment is in place. Investors therefore avoid making large commitments in high-debt environments.

Reducing sovereign debt is facilitated by political stability

Polarized political systems find it difficult to reduce debt positions and encourage growth. The research emphasizes that stable political systems are not synonymous with low turnover.

If an economy wishes to borrow, the fiscal authority should run surpluses

This recommendation may sound counter-intuitive, but follows from the premise that sovereign debt necessarily leads to distortionary taxation when the debt comes due. These distortions are minimized by a fiscal policy in which private agents are ultimately liable for the country's debt. Such a policy requires front-loading labor taxes.

Implementation

The research documents that the growth experience of developing economies is linked to international capital flows. Specifically, the countries with relatively high growth rates have grown while paying down sovereign debt and/or accumulating international reserves. This is shown in Figure 1 for poor and middle-income countries, and Figure 2 for the poorest economies. This phenomenon is not a result of business cycle fluctuations or differences in initial debt positions. In contrast to sovereign debt, private foreign liabilities are not negatively correlated with growth.

"Paying down sovereign debt requires political stability. Current incumbents must save tax revenues rather than spend the revenues while in office"

Action Point: Prolonged growth is facilitated by reducing sovereign debt and accumulating foreign reserves

The authors develop an economic model in which sovereign debt leads to high capital taxation. This arises because once capital is in place, the resulting income stream provides a tempting source of revenue to service the debt. However, investment is forward looking by nature, and investors anticipate a low after-tax return in a high debt environment. A credible investment-friendly environment therefore requires low levels of sovereign debt.

Action Point: A low debt level opens the way for a secure environment for capital income and low rates of capital taxation, which are contributors to investment and growth

Paying down sovereign debt requires political stability. Current incumbents must save tax revenues rather than spend the revenues while in office. That is, the cost of retiring debt is borne by the current incumbent, while the benefits accrue primarily to future politicians. A high-growth, low-debt fiscal policy is feasible if political parties agree on core priorities or if political parties have a high probability of returning to power conditional on losing office. This latter point indicates that political turnover per se is not detrimental, as long as turnover occurs as part of a regular cycle.

"It is important that political or constitutional mechanisms are in place to ensure today's fiscal surpluses cannot be squandered by future political incumbents"

Action Point: Creating a fiscal framework in which incumbents do not face an incentive for over-spending is crucial to growth

Specifically, it is important that political or constitutional mechanisms are in place to ensure today's fiscal surpluses cannot be squandered by future political incumbents.

If private consumption needs are such that is necessary to forgo high investment and borrow from abroad, the fiscal authority should nevertheless run surpluses. This can be implemented by allowing private agents to borrow from abroad (perhaps with a tax), or to borrow from a government agency that in turn borrows from abroad. That is, the government should raise taxes today in order to sustain a low-tax environment in the future. Such a policy allows the country to borrow in a manner that minimizes tax distortions. This is so because a conservative fiscal policy allows the economy to operate efficiently when the debt is due. Only in such an environment are bond markets willing to allow the economy to borrow.

Action Point: If private citizens have pressing needs to borrow against future income, the government should enforce private debt contracts to the extent possible and minimize future tax burdens

This requires shifting the tax burden towards the present to create fiscal space for lower tax rates in the future.

Figure 1: Emerging Markets: GDP per capita 1970 < USD 10,000 in year 2000 dollars

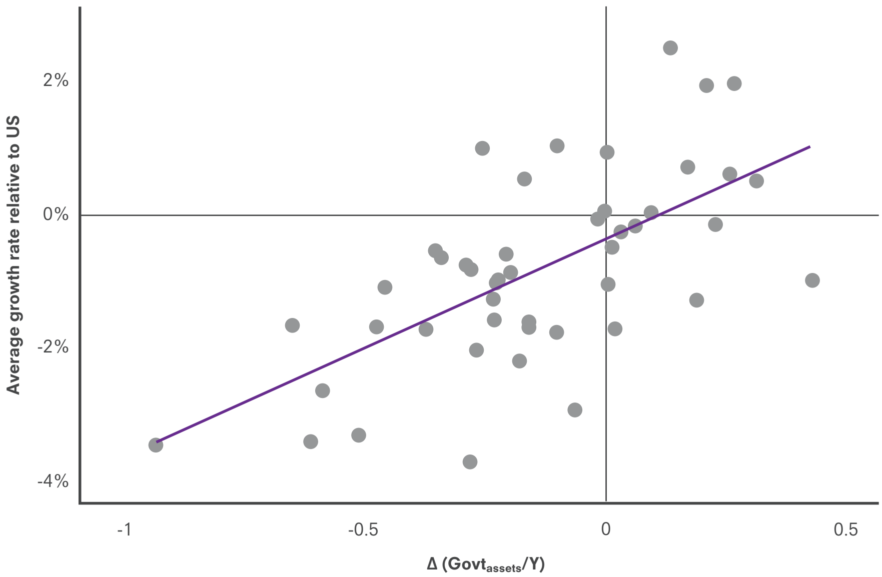
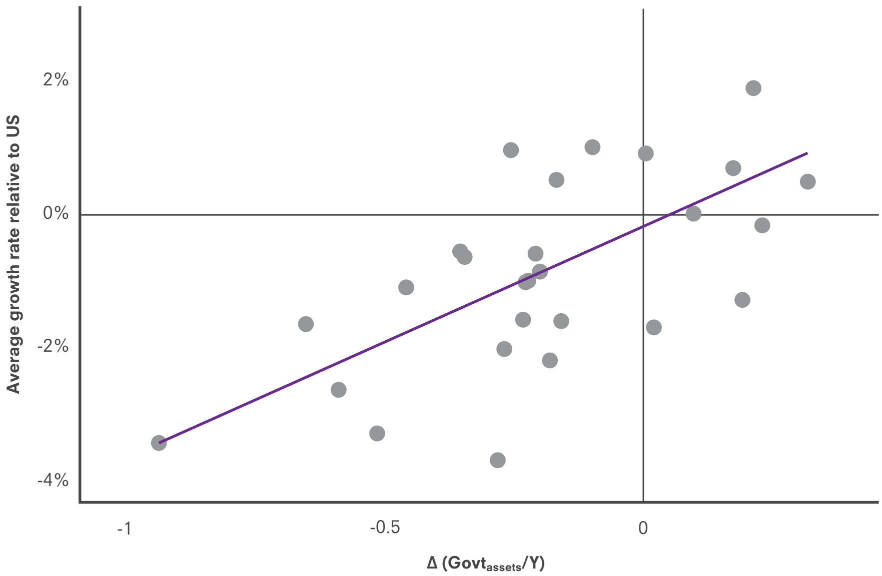


Figure 2: Poorest Countries: GDP per capita 1970 < USD 10,000 in year 2000 dollars



Further Reading

Aguiar, Mark and Manuel Amador, “Growth in the Shadow of Expropriation,” *Quarterly Journal of Economics*, scheduled for May 2011.

Aguiar, Mark and Manuel Amador, “Fiscal Policy in Debt Constrained Economies,” working paper.

About the authors

Mark Aguiar is currently Professor of Economics at Princeton University. His research focuses on models of consumption and savings with applications in both open- and closed-economy macroeconomics. Specific interests include life cycle consumption and savings, current account dynamics, sovereign debt, and the interplay of time allocation and consumption. His research on these topics has appeared in top economic journals including the American Economic Review, Journal of Political Economy, and the Quarterly Journal of Economics. Professor Aguiar received the 2006 TIAA-CREF Paul Samuelson Award for the best published paper dealing with household financial security for his joint work with Erik Hurst.

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