Ramsey Optimal Fiscal Policy in Emerging Countries: Is it Procyclical?

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Abstract

The purpose of this paper is to investigate the role of financial market imperfections in explaining the procyclical fiscal policy in many of the emerging developing countries. Procyclicality implies that business cycle booms and recessions are accentuated by the government policies. I examine whether, in the presence of distortionary taxation, procyclical fiscal policy can be an optimal outcome for a Ramsey planner in a one good, representative agent small open economy model with only friction being an upward sloping supply curve for loans from an incomplete international financial market. The loan suply function captures the well-known negative correlation between the interest rate and output in emerging countries. The paper shows that the observed procyclicality of the fiscal variables may indeed be an optimal outcome as debt financing of deficit becomes expensive during a recession due to the upward slope of the loan supply function.

Keywords: Procyclical fiscal policy, Ramsey optimal policy
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