A hands on approach to optimal budgetary policy VERY PRELIMINARY VERSION, NOT TO BE QUOTED

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Abstract

The demise of Lehman Brothers and the subsequent financial crisis led to serious problems for public finance in many countries. Now that the most acute problems of the crisis have been dealt with, countries face the question of how to restore equilibrium in their public finances. What is the optimal speed of fiscal consolidation? This paper seeks a pragmatic answer to this question. We combine a simple VAR model with gdp-growth, unemployment, public sector's primary surplus, and public debt with a welfare function with (current and future) gdp and unemployment as its arguments. The VAR model is easy to estimate. The optimal policy strikes a balance between stabilizing unemployment and controlling public debt. We calculate the welfare gain of applying the optimal policy rule compared to applying alternative rules, like stabilizing the primary surplus, public debt or unemployment.