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Fiscal Dominance as an Institutional Equilibrium

The Political Economy of Inflationary Persistence in Argentina

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Abstract

Argentina's recurrent fiscal dominance can be understood as a self-reinforcing institutional configuration rather than a succession of isolated policy errors. A political-economy framework links four mechanisms: common-pool expenditure bargaining, soft subnational budget constraints, the political choice between explicit taxation and inflationary finance, and credibility-dependent sovereign borrowing costs. Their interaction is central: weak fiscal cost internalization raises spending demands; politically costly taxation encourages the deferral or monetization of financing needs; credibility erosion then raises borrowing costs and can reduce the revenue obtainable from seigniorage. A compact analytical model derives expenditure and financing conditions and characterizes the credibility feedback, while distinguishing the Nash equilibrium of fiscal bargaining from the stationary configuration of the wider system. Descriptive evidence from Argentina's hyperinflation, convertibility and post-convertibility experiences, including federal and provincial fiscal balances, inflation outcomes and monetary financing, is used to assess the historical plausibility of these mechanisms. The fiscal adjustment initiated in 2024 and continued in 2025 is considered as a potentially relevant departure from earlier patterns, whose durability remains an open question. The evidence establishes historical consistency, not causal identification or an estimated structural model. Durable stabilization is therefore hypothesized to depend on institutional reforms that alter fiscal cost internalization, intergovernmental incentives and monetary-fiscal credibility, rather than on short-lived changes in policy instruments alone.

Keywords: fiscal dominance, political economy of deficits, common-pool problem, fiscal federalism, soft budget constraint, inflation tax, seigniorage, institutional path dependence, credibility.

JEL Classification: E31, E62, E63, H62, H77, P16.

1. Introduction

Argentina offers a recurrent puzzle in modern macroeconomic history. Over the past half century the country has experienced successive stabilization programs, monetary reforms,

* The author's viewpoints are personal and do not necessarily represent the position of the Universidad del CEMA.

sovereign defaults, fiscal adjustment plans, and full regime changes, and yet the configuration of high inflation, chronic fiscal imbalance, and monetary subordination reappears with remarkable regularity. Each episode of acute crisis produces a corrective response that seems, for a time, to break the pattern. Convertibility disciplined money for a decade, the post-2002 recovery restored primary surpluses, and repeated disinflation attempts promised a definitive turn. The pattern nonetheless returns. The question this paper addresses is why fiscal dominance persists in Argentina as a low-quality equilibrium even when its macroeconomic costs are widely understood by policymakers and by the public.

Conventional explanations tend to attribute the recurrence to bad policy, populist temptation, technical error, or a shortage of competent economists. These accounts are unsatisfying. Argentina has repeatedly relied on technically sophisticated stabilization teams, and the diagnosis of its fiscal and monetary imbalances has been available for decades. If the correct policy is known and its costs are visible, an explanation grounded in ignorance or incompetence cannot account for the persistence of the outcome. What is required instead is an explanation grounded in incentives. The policy observed over the long run is the policy that satisfies the political constraints of the actors who hold decision power, whether or not it satisfies the constraint of social efficiency. The gap between the politically selected equilibrium and the socially efficient one is precisely the space in which institutional political economy operates.[1]

The thesis advanced here is that Argentine fiscal dominance is best understood as a self-reinforcing institutional equilibrium generated by a political-institutional structure in which actors individually benefit from present expenditure while the intertemporal costs of fiscal imbalance are dispersed through inflation, debt dilution, monetary subordination, and credibility loss. Observed behavior is rational for each actor inside the game even though the aggregate outcome is socially inefficient. Under this reading the deficit is not an accident and inflation is not merely a symptom. The deficit is the predictable result of a set of political-institutional rules that generate systematic incentives toward the expansion of current spending, and inflation is a redistributive technology that distributes the cost of the imbalance in a politically functional manner, rendering the equilibrium self-sustaining even when it imposes significant real costs.[2]

[1]On the distinction between the socially optimal policy and the politically selected one as the object of positive political economy, see Persson and Tabellini (2000).

[2]Throughout, equilibrium is used in two related senses. The common-pool block is a Nash equilibrium in the strict game-theoretic sense, while the full framework defines a self-reinforcing institutional configuration, understood as a stationary point of the recursive system. Appendix A.6 states the distinction formally. Neither concept implies Pareto efficiency.

The contribution is not simply to collect four existing literatures in one account. Its analytical object is the interaction among four margins that are often treated separately: fiscal demands under a common-pool externality, intergovernmental bailout expectations, the political allocation of financing between taxation and inflation, and the feedback from credibility to the cost of sovereign debt and the capacity to levy seigniorage. The model identifies a sequential transmission mechanism. Lower fiscal-cost internalization increases politically selected expenditure; a given revenue path then generates a greater financing requirement; the relative political costs of taxation and inflation determine the short-run mix, while borrowing shifts part of the burden over time; and credibility loss tightens the intertemporal financing problem, potentially renewing pressure for monetary accommodation. This link is the proposed contribution: the same institutional parameters help explain both the generation of fiscal imbalance and the difficulty of sustaining nominal stabilization. The formal model provides signed conditional comparative statics, not an estimated causal decomposition; Sections 8 and 9 investigate whether the historical record is compatible with its mechanism and where the framework remains contestable.

This formulation yields observable implications rather than only an ex post interpretation. Periods with weak provincial revenue responsibility or soft bailout expectations should display larger fiscal pressures; limited access to debt markets should be associated with greater pressure for monetary financing or adjustment; and stabilization anchored in fiscal institutions should be more persistent than a monetary rule unsupported by credible fiscal commitments. These are conditional propositions, because external shocks, debt denomination, institutional reforms and changes in policy regime can also affect the outcomes. The analysis therefore distinguishes descriptive congruence from causal verification.

The remainder of the paper proceeds as follows. Section 2 reviews the relevant literature in four blocks. Section 3 develops the formal framework, moving from the intertemporal government budget constraint to a common-pool fiscal game, then to a government financing problem, and finally to the dynamics of credibility, and it collects the results in three propositions and a conjecture. Sections 4 through 7 examine the four mechanisms that sustain the equilibrium, namely the common-pool problem, fiscal federalism and soft budget constraints, inflation as a redistributive technology, and credibility with path dependence. Section 8 applies the framework to Argentine history in three moments. Section 9 develops a qualitative institutional benchmark drawing on Chile's fiscal rule and on Canada's federal arrangements. Section 10 draws the institutional implications, and Section 11 concludes.

2. Literature Review

2.1 Fiscal dominance and monetary-fiscal interactions

The first analytical pillar is the recognition that inflation cannot be understood through monetary policy alone when the fiscal trajectory lacks credibility. The foundational statement of this idea is due to Sargent and Wallace (1981), whose unpleasant monetarist arithmetic showed that when the fiscal path is taken as given and is not sustainable, a monetary tightening today merely postpones and enlarges the inflation required tomorrow, since the present value of seigniorage must still adjust to close the intertemporal gap. Leeper (1991) formalized the same interaction through the distinction between active and passive policies, establishing that a determinate low-inflation equilibrium requires a coherent assignment in which one authority stabilizes debt while the other anchors the price level, and that fiscal dominance is precisely the configuration in which fiscal policy is active and monetary policy is forced into a passive, accommodating role. These two contributions frame the entire argument, because they locate the source of inflation in the monetary-fiscal regime rather than in monetary conduct alone.

Sargent (1982) showed, in his study of the great interwar inflations, that durable stabilizations required deep fiscal reforms that modified the parameters of the game rather than mere changes in monetary instruments within an unchanged fiscal structure. The lesson is that the sustainability of the fiscal path is a precondition for monetary control, since a central bank that must ultimately finance the treasury cannot anchor the price level by managing the money supply in isolation. Cagan (1956) provided the analytical foundation for the demand for money under high inflation and identified the seigniorage-maximizing inflation rate beyond which further monetary expansion reduces rather than increases the real resources available to the government. That result becomes central once the fiscal authority approaches the peak of the seigniorage curve, a configuration relevant to the Argentine hyperinflation that the framework below formalizes as a feasibility boundary on the inflation instrument.

2.2 Time inconsistency and credibility

The second pillar concerns why stabilization announcements fail when agents anticipate future deviations. Kydland and Prescott (1977) established that optimal plans are time-inconsistent when the policymaker retains discretion, so that rules rather than discretion are required to sustain a low-inflation outcome. Barro and Gordon (1983) extended the argument into a repeated-game setting and showed that reputation can partially substitute for a binding rule,

since the expectation of future punishment for a deviation can sustain lower inflation, but only when the policymaker is patient enough and the reputational mechanism is credible. This result matters for the present argument, because where the institutional environment makes reputational punishment weak or the effective horizon short, the discretionary inflation bias reasserts itself and the low-inflation equilibrium unravels. The implication is direct. A government that cannot commit will be expected to inflate once private expectations are set, and rational agents will therefore price that deviation in advance, which raises the cost of any new disinflation attempt and can neutralize it before it begins. Credibility, in this framework, is not a rhetorical attribute but a structural property of the institutional arrangement that determines whether commitments are believed. The framework developed here treats credibility as a state variable with its own law of motion, so that the time-inconsistency problem becomes dynamic rather than static, and the erosion of credibility becomes both a consequence and a cause of fiscal dominance.

2.3 The political economy of deficits

The third pillar explains why deficits can be politically rational. Alesina and Tabellini (1990) modeled how governments with short electoral horizons have systematic incentives to finance current spending through debt, transferring the servicing cost to future administrations they may not form. Persson and Svensson (1989) added the seemingly paradoxical result that even a fiscally conservative government facing a likely defeat may rationally run a deficit to constrain the spending capacity of its successor, which shows that debt accumulation can be strategically rational independently of policy preferences. Alesina and Drazen (1991) formalized delayed stabilization as a war of attrition among distributive groups, each waiting for the other to bear the cost of adjustment, with acute crisis operating as the resolution device. Rogoff and Sibert (1988) showed that political budget cycles, in which incumbents distort fiscal policy ahead of elections, can arise as the equilibrium of a signaling game, and Shi and Svensson (2006) documented such cycles in a large panel of countries, finding them larger and more robust in developing economies. The common thread is that fiscal imbalance is an equilibrium of a strategic interaction, not a lapse of judgment.

A related strand analyzes the microeconomic pressure that organized groups exert on spending. Stigler (1971) argued that regulation is supplied to the industries that demand it, Peltzman (1976) generalized the result into a theory of political support maximization, and Becker (1983) modeled competition among pressure groups and showed that the equilibrium favors transfers that minimize deadweight loss without maximizing aggregate welfare. Grossman and Helpman

(1994) formalized the sale of protection to organized lobbies, and Weingast et al. (1981) traced the legislative logic through which the concentrated benefits of a program and the diffuse distribution of its costs generate a systematic bias toward excessive spending. Clientelism reinforces the same bias. Kitschelt and Wilkinson (2007) distinguished programmatic distribution from clientelistic exchange, Robinson and Verdier (2013) modeled public employment as the central instrument of clientelistic insurance, and Stokes et al. (2013) documented the machinery of distributive politics through which resources are traded for political loyalty. Cox and McCubbins (2001) showed that broad and heterogeneous coalitions face greater difficulty implementing adjustment because they must compensate a larger number of losing groups.

The political economy of populist macroeconomics belongs to the same family. Dornbusch and Edwards (1991) described a strategy that prioritizes short-run consumption and redistribution while ignoring the balance-of-payments and fiscal constraints, and characterized it as political rationality under short horizons rather than irrationality. Sachs (1989) traced the social-conflict roots of such policies, and Cardoso and Helwege (1991) extended the analysis into a predictable cycle running from initial expansion through payments tensions and price controls to collapse. Cukierman et al. (1992) linked political fragmentation and instability to greater reliance on seigniorage, since the inflation tax becomes the instrument of least short-run political cost where conventional taxation is politically or administratively constrained. Desai et al. (2003) closed the loop by relating democracy, inequality, and inflation, showing that the effect of democracy on inflation depends on income inequality and is associated with higher inflation where inequality is high.

2.4 Institutions, federalism, and path dependence

The fourth pillar locates the argument within institutional analysis. North (1990) argued that institutions exhibit path dependence, generating increasing returns that make departure from an established trajectory costly even when the trajectory is inefficient. Acemoglu and Robinson (2008) formalized the persistence of power and institutions, showing how groups with political power in an existing regime can block reforms that would reduce their relative position even when those reforms would raise aggregate welfare, and later generalized the analysis of institutional transitions toward the conditions under which societies escape low-quality equilibria (Acemoglu & Robinson, 2012). Aghion et al. (2004) showed that the degree to which political leaders are insulated from opposition is itself chosen endogenously, so that the rules governing reform reflect the interests of those who set them. On fiscal federalism specifically,

Oates (1972) established the conditions under which decentralization improves allocation and the conditions under which it fails, Weingast (1995) introduced market-preserving federalism and the role of hard subnational budget constraints, and Rodden (2006) showed, on broad cross-national evidence, that the credibility of the center's no-bailout commitment is central to subnational fiscal discipline. Kornai (1980) supplied the underlying concept of the soft budget constraint, and Inman (1988) traced how federal assistance shapes the fiscal choices of local governments. Bordo et al. (2013) drew the historical lessons of monetary unions and subnational fiscal crises, Acuña and Tommasi (1999) analyzed the institutional reforms that Latin American fiscal systems would require, Besley and Persson (2011) showed that robust fiscal institutions demand deliberate political investment, and Frankel (2011) analyzed the Chilean structural-balance rule as an instance of such investment. Riker (1962) supplied the theory of minimum winning coalitions, which Gibson and Calvo (2000) and Porto and Sanguinetti (2001) applied to Argentine intergovernmental transfers, while Rodrik (1996) and Haggard and Kaufman (1995) examined the political conditions of reform. The mechanism sections also draw on the analysis of prospective deficits (Burnside et al., 2001), exchange-rate-based stabilization (Kiguel & Liviatan, 1992), the composition of the tax base (Aizenman & Jinjarak, 2009), and the inflationary erosion and liquidation of public debt (Aizenman & Marion, 2011; Reinhart & Sbrancia, 2015).

The contribution of this paper is to connect these strands into a single political-economy mechanism. Fiscal dominance is treated neither as a purely monetary-fiscal inconsistency nor as a generic failure of fiscal discipline, but as an institutional equilibrium in which common-pool incentives, soft budget constraints, inflationary finance, and credibility erosion jointly reproduce one another. Each of the four literatures reviewed above isolates one face of the problem, and the analytical gain of treating them together is that the mechanisms are shown to be mutually reinforcing rather than additive, so that the equilibrium persists precisely because no single reform that leaves the others untouched can dislodge it.

2.5 Argentine fiscal institutions and the contribution of the integrated mechanism

For Argentina, the institutional bridge between the common-pool game and macroeconomic policy is more specific than the generic literature on fiscal decentralization suggests. Tommasi et al. (2001) analyze fiscal federalism as the outcome of political transactions shaped by allocation rules, provincial bargaining power and the difficulty of enforcing intertemporal

agreements. Spiller and Tommasi (2003) likewise interpret public policy as the product of intertemporal transactions among political actors whose institutional setting may inhibit durable cooperation. These contributions offer direct antecedents for the model's parameter θ_i: the internalized fiscal-cost share is not simply a technological constant but an outcome of the incentives embedded in revenue sharing, enforcement and expectations of rescue.

The proposed framework adds a monetary-fiscal transmission channel to that institutional account. In the first block, transfers and bailout expectations can weaken fiscal cost internalization. In the second, debt availability and the political salience of explicit taxes determine how an elevated expenditure demand is financed. In the third, inflation and default lower credibility, which raises the perceived cost of borrowing and narrows future fiscal choices. Thus the institutional arrangements that help generate spending pressures may also influence the terms on which those pressures are subsequently financed. Unlike a purely additive account, the result implies feedback: a loss of credibility changes the financing possibilities of the fiscal game itself.

The distinction matters for interpretation. Neither high inflation by itself nor a provincial deficit alone demonstrates an institutional equilibrium. A stronger historical case requires joint evidence on fiscal outcomes, monetary accommodation, intergovernmental incentives and the persistence or reversal of credibility constraints. The descriptive evidence presented below is organized around these linkages; it is not claimed to estimate θ_i, the perceived bailout probability or the parameters of the credibility process.

3. A Political-Economy Framework

This section develops the formal argument in four blocks. The first states the accounting identity that no fiscal imbalance can escape. The second models the generation of the deficit as the non-cooperative equilibrium of a common-pool game and derives, step by step, the wedge between the equilibrium and the efficient level of spending. The third models the government's choice among financing instruments and derives first-order conditions that rank explicit taxation and inflationary finance by political cost, with debt operating as the intertemporal margin of adjustment. The fourth introduces the law of motion for credibility and closes the loop through the interest rate and the debt dynamics. The four blocks are then collected in three propositions and a conjecture. The specification is linear-quadratic wherever a closed form clarifies the logic, and the emphasis throughout is on the sign and interpretation of each condition rather than on

numerical magnitudes. The derivations, the proofs of each proposition, and the closed-form solutions of the local linear-quadratic specification of each block are collected in Appendix A.[3]

3.1 The intertemporal government budget constraint

Let B_t denote the real stock of public debt, and let G_t, T_t, and S_t be expressed in real terms. The government's flow budget constraint is

$$B_t = (1 + r_t)\, B_{t-1} + G_t - T_t - S_t \qquad (1)$$

Here B_t is real public debt at the end of period t, G_t is real primary expenditure, T_t is real tax revenue, S_t is real seigniorage or monetary financing, and r_t is the real interest rate. Dividing by real output and using lowercase letters for ratios to output, a first-order approximation of the law of motion for the debt-to-output ratio b_t is

$$\Delta b_t \approx (r_t - \gamma_t)\, b_{t-1} - pb_t - s_t \qquad (2)$$

Here γ_t is the growth rate of real output, pb_t is the primary balance relative to output, and s_t is seigniorage relative to output. Equation (2) is the workhorse of the entire argument. It states that the change in the debt ratio is driven by the interest-growth differential applied to inherited debt, net of the primary balance and of seigniorage. Iterating (1) forward and imposing the standard no-Ponzi condition yields the intertemporal constraint

$$B_{t-1} = \sum_{k=0}^{\infty} (1 + r)^{-(k+1)}\ (T_{t+k} + S_{t+k} - G_{t+k}) \qquad (3)$$

This expression is obtained under the standard transversality condition that rules out explosive debt accumulation, namely that the present value of public debt converges to zero in the limit. For notational simplicity, the expression is written under a constant real interest rate, though nothing of substance depends on this, since a time-varying rate would only replace the geometric factor by a product of period-specific discount factors. The dating convention is worth one remark, since it is the point at which an exponent is easily lost: the stock B_{t-1} is measured at the beginning of period t while the flows accrue over the course of it, so the first term of the sum is discounted by one full period and the general term carries the factor $(1 + r)$ raised to $-(k + 1)$. The equivalent convention writes the same identity with the exponent $-k$ on the right-hand

[3]The linear-quadratic specification is chosen for tractability and transparency rather than realism. Its virtue is that the first-order conditions admit closed-form comparative statics, so the direction of each effect can be read directly off the parameters. Inequality (8) and conditions (12) and (12a) hold under general convex specifications; the closed forms are used only to sign the comparative statics that the general specification leaves ambiguous.

side and the quantity $(1 + r) \cdot B_{t-1}$ on the left. Appendix A.2 derives (3) step by step. Condition (3) makes the central point unavoidable. Inherited debt must equal the present value of future primary surpluses augmented by the present value of future seigniorage. A government that cannot or will not generate primary surpluses must therefore rely on seigniorage, and if the present value of feasible seigniorage is still insufficient, the constraint can be satisfied only through an eventual restructuring that reduces the left-hand side. Fiscal dominance is precisely the regime in which the primary-surplus terms in (3) are set by the fiscal authority independently of the inherited debt, so that the seigniorage terms must adjust for the identity to hold and monetary policy loses control of inflation, as in Sargent and Wallace (1981). When public debt is nominal, the same adjustment can operate through the price level, which revalues the real debt on the left-hand side, as in the active-fiscal, passive-monetary configuration of Leeper (1991). The remaining blocks explain why the fiscal terms take the values they do.

3.2 A common-pool fiscal game

Consider n fiscal actors indexed by i, comprising the national government, the provinces, and organized distributive coalitions. Each actor chooses a spending demand $g_i \geq 0$ directed at its own constituency, and aggregate spending is

$$G = \sum_{i=1}^{n} g_i \qquad (4)$$

The aggregate fiscal cost of financing G is C(G), with $C'(G) > 0$ and $C''(G) > 0$, so that the marginal cost of public funds rises with the scale of spending. Actor i derives a political benefit $v_i(g_i)$ from its own spending, with $v_i' > 0$ and $v_i'' < 0$, but internalizes only a fraction $\theta_i \in (0, 1)$ of the aggregate cost. The payoff of actor i is

$$U_i = v_i(g_i) - \theta_i C(G) \qquad (5)$$

Each actor takes the spending of the others as given and chooses g_i to maximize (5). The first-order condition is

$$v_i'(g_i) = \theta_i C'(G) \qquad (6)$$

Condition (6) states that each actor equates the marginal political benefit of its own spending to its privately perceived marginal cost, which is only the fraction θ_i of the true marginal cost C'(G).

A benevolent planner who internalized the full cost would instead maximize the sum of benefits net of the full aggregate cost, yielding the efficient condition

$$v_i'(g_i) = C'(G) \qquad \text{for every } i \tag{7}$$

Comparing (6) and (7) exposes the wedge. Because $\theta_i < 1$, the marginal cost perceived by each actor in (6) is strictly below the social marginal cost in (7), so each actor demands more spending than is efficient. In the symmetric case where $\theta_i = 1/n$ for all i, which is the natural benchmark when the cost of any program is spread evenly across n jurisdictions, condition (6) becomes $v_i'(g_i) = (1/n) \cdot C'(G)$. The perceived marginal cost is then a fraction 1/n of the true one, and the resulting equilibrium spending exceeds the efficient level; the effect of n is characterized below under the symmetric linear-quadratic specification. Denoting the Nash and efficient aggregates by G^N and G^*, the comparison delivers

$$G^N > G^* \tag{8}$$

Inequality (8) is the central prediction of the common-pool model, and the comparative static established below records that the over-spending wedge widens with the number of actors able to appropriate the benefits of spending while socializing its cost. The result does not depend on any single special assumption. Variants with different voting structures, utility functions, and time horizons reproduce the same qualitative conclusion (Weingast et al., 1981; Persson & Tabellini, 2000), which is why the prediction is regarded as robust. The deficit emerges not because actors fail to understand the budget constraint but because each faces incentives not to internalize it fully, exactly as in the resource-depletion problem in which private appropriation of benefits and socialization of costs drive aggregate use above the efficient level.[4]

Inequality (8) holds for any functions satisfying the assumptions above, as Appendix A.3 shows. The comparative static in n requires more structure, since both the equilibrium and the efficient aggregate rise with n and the monotonicity of their difference cannot be signed from the general specification alone. The symmetric linear-quadratic case delivers it in closed form. Let $v_i(g_i) = a \cdot g_i - (h/2) \cdot g_i^2$, let $C(G) = (c/2) \cdot G^2$, and let $\theta_i = 1/n$, holding the aggregate cost function fixed as n varies so that n indexes the fragmentation of a given fiscal structure rather than the size of the economy. The equilibrium and the efficient aggregate are then

[4]The common-pool logic is isomorphic to the resource-depletion problem of Hardin (1968). When each user internalizes only a fraction of the aggregate cost of drawing on a shared resource, aggregate use exceeds the socially efficient level. In the fiscal case the shared resource is the state's spending capacity financed by taxes or debt.

$$G^N = \frac{n\,a}{h+c} \qquad \text{and} \qquad G^* = \frac{n\,a}{h+c\,n} \tag{8a}$$

so that the over-spending wedge and its derivative are

$$G^N - G^* = \frac{a\,c\,n\,(n-1)}{(h+c)(h+c\,n)} > 0 \tag{8b}$$

$$\frac{\partial\,(G^N - G^*)}{\partial n} = \frac{a\,c\,(2hn - h + c\,n^2)}{(h+c)(h+c\,n)^2} > 0 \tag{8c}$$

for every n > 1, which establishes the comparative static in n as a signed result rather than an intuition. Two features of the closed form deserve notice. The wedge vanishes at n = 1, as it must, since a single actor internalizing the whole cost faces the planner's problem. And the wedge grows without bound in n even though the efficient aggregate converges to the finite limit a/c, so that fragmentation does not merely displace the equilibrium but progressively detaches it from the efficient allocation.

Two features of θ_i carry the institutional content of the model. First, θ_i is smaller the more fragmented the fiscal system, since fragmentation multiplies the number of actors across whom the cost is spread. Second, θ_i falls further when a subnational actor expects the center to absorb its losses, because an anticipated bailout removes even the fraction of the cost the actor would otherwise bear. This is the point at which the common-pool model connects to the soft budget constraint of Kornai (1980), developed in Section 5. For present purposes it is enough to note that any institutional feature that lowers θ_i raises equilibrium spending, and that Argentine fiscal federalism can be read as an institutional mechanism that lowers θ_i.

3.3 The financing problem and the ranking of instruments

Given the spending path generated by the common-pool game, the government chooses how to finance it. The problem is stated in two stages, and the order matters. The first stage allocates a given residual financing requirement between explicit taxation and the inflation tax; the second chooses that requirement itself through the debt path. The two-stage structure is what prevents debt from entering as a costless third instrument, since a formulation in which taxes, inflation and borrowing were chosen simultaneously would attach no cost whatever to borrowing and would have no interior solution. Let the government maximize the discounted stream of political payoffs

$$\max \sum_{t=0}^{\infty} \beta^t \left[V(G_t) - C_T(T_t) - \lambda \pi_t^2 - \mu D_t \right] \tag{9}$$

subject, in each period, to the flow financing identity implied by (1),

$$G_t + r_t B_{t-1} = T_t + \sigma(\pi_t, \Theta_t) + \Delta B_t \tag{10}$$

which states that primary expenditure and interest service together must be met by taxation, seigniorage and net new borrowing. Defining the residual financing requirement as the part of that need which is not covered by net new borrowing,

$$F_t \equiv G_t + r_t B_{t-1} - \Delta B_t = T_t + \sigma(\pi_t, \Theta_t) \tag{10a}$$

Here $V(G_t)$ is the political benefit of spending, $C_T(T_t)$ is the political cost of raising taxes with $C_T' > 0$ and $C_T'' > 0$, π_t is inflation, D_t is an indicator of default or restructuring, $\beta \in (0,1)$ is the political discount factor, $\lambda > 0$ is the political weight on the inflationary cost, and $\mu > 0$ is the political weight on the reputational cost of default. Seigniorage is linked to inflation and to credibility through the reduced-form relation $S_t = \sigma(\pi_t, \Theta_t)$, which is increasing and concave in inflation over the relevant range, increasing in the credibility stock Θ_t introduced in Section 3.4, and which reaches a maximum at the seigniorage-maximizing rate identified by Cagan (1956) before declining as money demand collapses. The maintained assumptions are that the partial derivative of σ with respect to inflation is positive and decreasing in inflation, that the partial derivative with respect to credibility is positive, and that the cross-partial derivative is positive, the last of which states that greater credibility raises the marginal yield of the inflation tax by sustaining the demand for real balances. Credibility therefore enters the financing block through the equations rather than only through the surrounding discussion. Taking first-order conditions of the first-stage problem with respect to the tax and inflation instruments, for a given residual requirement F_t, yields at an interior optimum

$$C_T'(T_t) = \xi_t \qquad \text{and} \qquad 2\lambda \pi_t = \xi_t \sigma_\pi(\pi_t, \Theta_t) \tag{11}$$

Here ξ_t is the multiplier on the financing constraint, interpretable as the marginal political value of relaxing the residual financing requirement by one unit. Combining the two conditions in (11) eliminates the multiplier and gives the instrument-ranking condition

$$2\lambda \pi_t = C_T'(T_t)\, \sigma_\pi(\pi_t, \Theta_t) \tag{12}$$

Condition (12) fixes the mix of instruments but not the scale of the requirement to be financed, which is settled at the second stage. Raising the debt stock B_t by one unit lowers F_t by one unit

and raises F_{t+1} by one plus the interest rate, so the optimal debt path equates the marginal political cost of financing across adjacent periods,

$$\xi_t = \beta\,(1 + r_{t+1})\,\xi_{t+1}, \qquad \xi_t = \Phi'(F_t; \Theta_t) \qquad (12a)$$

where $\Phi(F_t; \Theta_t)$ denotes the minimized political cost of covering the residual requirement, so that ξ_t is its derivative and is increasing in F_t. Condition (12a) prices debt explicitly. A unit of borrowing today is worth the discounted marginal political cost of the financing it will require tomorrow, which is why debt operates as the intertemporal margin of adjustment rather than as a free instrument. The condition also makes the role of the political horizon transparent. When the product of β and the gross interest rate is below one, the equality can hold only if the marginal cost of financing rises over time, and since that cost is increasing in the requirement, the requirement itself must rise for a given credibility stock: an impatient government defers the burden and borrows in the present. When the product equals one the burden is smoothed perfectly, and when it exceeds one the burden is front-loaded. Equation (12a) is a conditional intertemporal financing condition, derived holding the anticipated path of credibility and future borrowing rates fixed. If current borrowing is allowed to alter future credibility through inflation and sovereign risk, the fully integrated dynamic optimization would require an additional co-state condition for Θ. The present framework instead combines a conditional financing optimum with an explicit credibility feedback, without claiming to solve a fully specified dynamic political game. Appendix A.4 derives (12a), establishes the convexity of Φ on which the argument rests, and solves the block in closed form. The convexity of Φ also links the financing block to the common-pool block: the aggregate fiscal cost C(G) in (5) can be read as the reduced form of Φ evaluated at the financing requirement that spending G generates, so the assumption $C''(G) > 0$ is the counterpart of the convexity established in Lemma A.2.

Condition (12) is the analytical heart of the financing block. It equates, at the margin, the political cost of a marginal unit of inflation on the left with the product of the political cost of taxation and the seigniorage yield of inflation on the right. The comparative statics are immediate and carry the argument. When the political cost of taxation C_T' is high, the right-hand side is large, so the government optimally tolerates more inflation, which is the formal statement of the claim that inflation substitutes for taxation when taxation is politically expensive. When the political weight λ on inflation is low, because its incidence is diffuse and hard to attribute, the left-hand side is small for any given inflation rate, so again the optimal inflation rate rises. A fall in credibility reduces the marginal yield of the inflation tax $\sigma_\pi(\pi_t, \Theta_t)$ and contracts the maximum

seigniorage that can be raised. Holding the residual financing requirement fixed, its effect on the optimal inflation rate is generally ambiguous, because the government can substitute toward taxation. Once the debt-service channel through r_t is included, Proposition A.4 provides a sufficient condition under which lower credibility raises optimal inflation. The government's revealed preference for inflation over explicit taxation is therefore not a preference over outcomes but a response to the relative political prices of the instruments.

3.4 Credibility and self-reinforcing fiscal dominance

The final block makes credibility a state variable rather than a parameter. Let institutional credibility Θ_t evolve on the interval from zero to one according to

$$\Theta_{t+1} = \Pi_{[0,1]}\left(\rho\,\Theta_t - \alpha\,\pi_t - \delta\,D_t + \eta\,R_t\right) \qquad (13)$$

where $\Pi_{[0,1]}$ is a projection operator that keeps credibility bounded between zero and one, $\rho \in (0,1)$ is the persistence of credibility, $\alpha > 0$ measures how strongly realized inflation erodes it, $\delta > 0$ measures the reputational damage of default, and $\eta > 0$ measures the credibility gained from the institutional effort R_t, interpreted broadly as the ongoing flow of commitment, enforcement and compliance that sustains credible institutions rather than exclusively as one-off legal reforms. The projection makes explicit that (13) is a bounded reduced form, so that the argument inside the operator may move freely while the credibility stock itself never leaves the unit interval. For constant inflation, default incidence and institutional effort, an interior stationary credibility stock exists only when $\eta R - \alpha\pi - \delta D$ is positive and below $1 - \varrho$, in which case it equals $(\eta R - \alpha\pi - \delta D)/(1 - \varrho)$; when $\eta R - \alpha\pi - \delta D$ is at least $1 - \varrho$, credibility converges to the upper bound. In particular, with $R = 0$ credibility decays toward zero even in the absence of inflation and default, and with positive inflation zero is absorbing, so sustained positive credibility requires a persistent flow of institutional effort. The real interest rate faced by the government is increasing in the credibility deficit,

$$r_t = r^f + \kappa\,(1 - \Theta_t), \qquad \kappa > 0 \qquad (14)$$

where r^f is the risk-free rate and κ is the sensitivity of the risk premium to the loss of credibility. Equations (13) and (14) close the model. Substituting (14) into the debt-dynamics equation (2) shows that a fall in credibility raises r_t, widens the interest-growth differential $(r_t - \gamma_t)$, and worsens the debt trajectory for any given primary balance. A deterioration in credibility therefore raises the cost of debt servicing and the residual financing requirement, all else equal. When conventional taxation and market financing are politically or economically constrained, the

resulting pressure may be accommodated through higher seigniorage, which raises π_t, erodes Θ_t further through (13), and raises r_t again through (14); alternative adjustments include expenditure cuts, tax changes, restructuring, or a price-level revaluation of nominal liabilities. The inflationary branch of the loop is therefore conditional, and it operates differently for nominal local-currency debt, whose real value inflation can erode, than for real or foreign-currency debt, whose value it cannot. When that branch operates, the loop is self-reinforcing. Low credibility is then not merely an outcome of fiscal dominance but one of the channels through which fiscal dominance can reproduce itself, and the reform term $\eta \cdot R_t$ in (13) provides the direct positive entry point through which credibility can be rebuilt. Appendix A.5 provides a sufficient condition for local instability of the joint debt-credibility dynamics.

The self-reinforcing structure also explains why the loop resists marginal intervention. A one-period reduction in inflation raises Θ_{t+1} only by α times that reduction, a quantity that may be small relative to the inherited credibility gap, whereas a credible institutional reform enters with weight η and, because it shifts the perceived law of motion itself, can move expectations discretely. This is consistent with the historical observation that isolated stabilization episodes have often faded, whereas changes in the underlying regime have tended to be more durable.[5]

3.5 Equilibrium and propositions

The full framework defines a self-reinforcing institutional configuration in which each fiscal actor's spending satisfies (6), the government's financing choice satisfies (12) and the conditional intertemporal condition (12a), credibility evolves according to (13), and the resulting allocation reproduces itself period after period. The common-pool block is a Nash equilibrium in the strict sense, since its players, action sets, payoffs and information are fully specified and the equilibrium is characterized by mutual best responses. The remaining blocks are better described as a self-reinforcing institutional configuration, that is, a stationary point of the recursive system formed by the financing problem and the credibility dynamics. A full game-theoretic treatment of that configuration would require the strategy sets and payoffs of private agents, the timing of moves, the information sets, and the off-path beliefs that sustain the low-credibility outcome after a deviation, and none of the results below depends on that additional structure. What the framework establishes is recursive consistency and stationarity rather than a fully specified

[5]A fuller dynamic treatment would specify the transition probabilities across regimes and the off-path beliefs that sustain the low-credibility configuration. The compact characterization here isolates the stationarity of the configuration, which is robust to those refinements; Remark A.1 in the appendix states precisely what the stronger claim would require.

strategic equilibrium. The national government cannot cut spending without losing its supporting coalition, the provinces cannot moderate their demands without losing relative position in the transfer bargain, and private agents cannot lower their inflation expectations without exposing themselves to real losses if the regime continues. The three central results, together with a conjecture on regime change, can now be stated compactly.

Proposition 1. Under the maintained interiority and uniqueness conditions, when political actors internalize the concentrated benefits of current expenditure but externalize a fraction $(1 - \theta_i)$ of its intertemporal cost, with $\theta_i < 1$, the non-cooperative equilibrium level of public spending — and, for a given revenue path, the fiscal deficit — exceeds the socially optimal level. In the symmetric case the excess is decreasing in the common internalized share θ, and under the symmetric linear-quadratic specification it is increasing in the number of actors n. This follows from the comparison of (6) and (7) and from the comparative static in (8c), established in Propositions A.1 and A.2.

Proposition 2. For a given residual financing requirement and an interior solution, condition (12) implies that the optimal inflation rate rises when the political cost of taxation C_T' is high and when the political weight λ on inflation is low. A deterioration in credibility contracts seigniorage capacity and, through the debt-service channel, raises optimal inflation under the condition stated in Proposition A.4. Inflation can therefore be politically functional, distributing the cost of fiscal imbalance across diffuse and weakly organized groups rather than concentrating it on identifiable taxpayers. The comparative statics are signed in Proposition A.3.

Proposition 3 (conditional persistence). Under the maintained credibility process and absent a sufficiently persistent change in fiscal cost internalization, bailout expectations or institutional commitment, a temporary policy-instrument intervention need not generate a lasting shift in the underlying financing configuration. The model identifies mechanisms of reversion rather than establishing that every instrument-based stabilization must fail. In the model, a durable shift requires a change in the structural components of the configuration, such as the internalized cost shares θ_i, the political weight λ, and the institutional effort R_t. The term $\eta \cdot R_t$ is the direct positive reform channel in the credibility law of motion, and Proposition A.8 states the minimum size such an effort must have to lift credibility from zero.

Conjecture. A regime change occurs only when the accumulated cost of the status quo pushes the value of reform above the value of continuation. Following the war-of-attrition logic, the switch happens when the difference $W^R(\Theta) - W^S(\Theta)$ between the political values of reform and

of the status quo exceeds a threshold that is more easily crossed the lower is the inherited credibility stock Θ and the higher is the current cost of the status quo. The statement is a reduced-form representation rather than a derived result, since the war of attrition is not modeled explicitly in Appendix A. It is also distinct from Proposition A.8, which concerns the size of the reform required once a switch is undertaken: a low credibility stock may make a reform more likely to be attempted while raising the reform effort needed to restore credibility. Reforms initiated at the moment of crisis may therefore address the most visible symptoms while leaving the deeper parameters intact, which regenerates the conditions for the next crisis.[6]

3.6 Cross-block transmission and empirical implications

The contribution of joining the blocks can be stated as a propagation chain. Let fiscal fragmentation and soft budget constraints lower the privately internalized share θ_i. Through (6)–(8), this raises desired expenditure relative to the social benchmark, conditional on preferences and the cost technology. Given tax revenue and access to borrowing, the higher financing requirement F_t enters (10a). Condition (12) then determines the politically preferred tax–seigniorage margin, while (12a) spreads residual costs across time. If the authorities resort to inflation or restructuring, (13) weakens credibility; through (14), the resulting risk premium increases debt service, feeding into the next financing requirement. This closes an institutional feedback loop rather than leaving four self-contained explanations side by side.

The chain does not imply that a larger fiscal deficit mechanically produces inflation every year. Access to debt markets, exchange-rate arrangements, demand for real money, external shocks and the government's capacity to increase explicit taxes affect the adjustment margin. The model predicts stronger inflationary pressure when borrowing is constrained and the political cost of taxation is comparatively high; when credible nonmonetary finance is available, fiscal demands may instead appear in debt accumulation. This conditionality is important for interpreting convertibility, when nominal stability coexisted for a time with fiscal vulnerability, and the subsequent reopening of monetary financing channels.

Three empirical signatures are relevant. First, consolidated fiscal deterioration should be visible across federal and provincial accounts when common-pool and soft-budget pressures intensify. Second, when ordinary financing is restricted, fiscal accommodation should appear in central-

[6]The threshold condition is a reduced-form representation of the war-of-attrition logic of Alesina and Drazen (1991). The precise value of the threshold depends on the distribution of adjustment costs across groups and on the rate at which each group discounts the future, neither of which is directly observable.

bank financing, quasi-fiscal liabilities or explicit adjustments in the public sector. Third, a durable fiscal-regime change should weaken the link between financing needs and monetary accommodation. The tables in Section 8 provide descriptive anchors for these signatures, while the limitations of the available evidence are stated explicitly.

4. Mechanism I: The Common-Pool Fiscal Problem

The analytical departure point is the common-pool fiscal problem introduced by Weingast et al. (1981) in the study of representative systems. In a polity with multiple representatives, each defending the interests of a distinct constituency, the cost of any spending program is spread across all taxpayers while its benefits concentrate in the constituency of the legislator who promotes it. Each representative therefore faces the fiscal externality formalized in condition (6), internalizing the benefits of local spending fully but only the fraction θ_i of its cost. The prediction of the model, recorded in (8), is that decentralized equilibrium spending exceeds the level a social planner would choose. Under the symmetric linear-quadratic specification, equation (8c) further establishes that the over-spending wedge increases with the number of actors able to appropriate benefits. The deficit is the predictable consequence of a system in which each actor can privatize the benefits of spending and socialize its costs. The microfoundations of that appropriation are supplied by the interest-group tradition. Stigler (1971), Peltzman (1976), and Becker (1983) showed that policy reflects the balance of organized pressure rather than the choices of a benevolent planner, and Grossman and Helpman (1994) formalized the sale of protection to organized lobbies, so that the actors indexed by i in the model are best understood as organized constituencies with differing capacities to convert spending into political support.

A second dimension concerns time horizons. Alesina and Tabellini (1990) showed that governments with short electoral horizons systematically finance present spending with debt, since the incumbent captures the electoral benefit of current spending but does not bear the servicing cost if it loses office. In the notation of the financing problem, a short horizon corresponds to a low political discount factor β, and condition (12a) states the consequence formally: when the product of β and the gross interest rate falls below one, the marginal political cost of financing must rise over time, so the residual requirement is deferred and current borrowing rises. The tilt toward deficit finance is a property of the optimum rather than an assumption about preferences. Persson and Svensson (1989) demonstrated that even a conservative government facing likely defeat may rationally accumulate debt to tie the hands of

its successor, so that deficits can be strategically rational even for actors who nominally prefer balance. Rogoff and Sibert (1988) showed that such cycles can arise as an equilibrium outcome, and Shi and Svensson (2006) found them to be larger in developing than in developed economies. The Argentine pattern of fiscal deterioration ahead of electoral turnover is consistent with these mechanisms, and the cross-country evidence that such cycles are larger in developing economies suggests that the institutional structure may amplify the mechanism rather than merely permit it.

The war-of-attrition logic of Alesina and Drazen (1991) completes the picture and supplies the threshold in the Conjecture. Two groups, which may represent economic sectors, parties, or levels of government, each prefer that the other absorb the cost of consolidation, and the equilibrium is a waiting game in which both delay until the accumulated cost of non-adjustment crosses one group's tolerance. Acute crisis is the resolution device, and late stabilizations are more costly than early ones because the deterioration accumulated during the waiting game amplifies the required adjustment. Read through this lens, the Argentine sequence of the past half century appears as a succession of fiscal wars of attrition, in which the hyperinflation of the late 1980s resolved a conflict that had opened in the mid-1970s, the collapse at the turn of the century resolved the tensions accumulated during the preceding decade, and each late resolution plausibly imposed a larger loss of output and contractual capacity than an early adjustment would have required. The clientelistic dimension deepens the delay. Kitschelt and Wilkinson (2007) distinguished programmatic from clientelistic distribution, Robinson and Verdier (2013) modeled public employment as a device of political insurance that sustains employment above the efficient level, and Stokes et al. (2013) documented the brokerage networks through which resources are exchanged for loyalty, so that a spending cut is not merely a welfare loss for beneficiaries but a dismantling of the incumbent's coalition, which raises the political cost of adjustment and, through Cox and McCubbins (2001), is harder to implement the broader and more heterogeneous the coalition. Dornbusch and Edwards (1991), Sachs (1989), and Cardoso and Helwege (1991) supply the macroeconomic counterpart in the populist cycle, in which the same incentives generate expansion, payments tension, controls, and collapse.

5. Mechanism II: Fiscal Federalism and Soft Budget Constraints

Fiscal federalism transforms fiscal dominance from a central-government problem into a multi-level institutional equilibrium, and in the notation of Section 3 it is the mechanism that, in the model, lowers the internalized cost share θ_i. Oates (1972) established that decentralization

improves allocation when local preferences are heterogeneous, but also identified the conditions under which it fails, namely when subnational governments can externalize costs to the center through borrowing implicitly backed by the national government or through the capture of shared revenue without corresponding tax responsibility. The outcome in that case is excessive subnational spending and a larger consolidated deficit, which is exactly the prediction of (8) once federal fragmentation raises n and the expectation of transfers lowers θ_i. Rodden (2006), drawing on broad cross-national evidence, found that subnational fiscal discipline depends critically on the hardness of the budget constraint. Where subnational governments cannot expect central bailouts and must raise their own resources to finance their spending, consolidated deficits are smaller, and where revenue sharing is broad, bailouts are frequent, and tax responsibility is diffuse, the opposite pattern prevails. Argentina is a particularly clear case of the second type, and Acuña and Tommasi (1999) described how veto power over the revenue-sharing regime turned fiscal bargaining into a process in which each actor extracted concessions in proportion to its bargaining power, with an aggregate spending path that systematically outran revenue.

The soft budget constraint introduced by Kornai (1980) and extended to federalism by Weingast (1995) captures the incentive structure precisely. A subnational unit operates under a soft constraint when it anticipates that the center will absorb its fiscal losses, and under that expectation it has an incentive to borrow beyond its repayment capacity and to expand current spending without a sustainable financing source. In reduced form, the perceived bailout probability φ can be treated as an implicit subsidy to borrowing, so that the perceived marginal cost of provincial debt becomes, in reduced form,

$$r_{\text{eff}} = (1 - \varphi)\, r \qquad (15)$$

Equation (15) is a stylized representation of the perceived marginal cost of borrowing, not a contractual interest rate observed in markets nor a general implication of every bailout regime, and it makes the mechanism transparent. As the perceived bailout probability φ approaches one, as provinces expect rescue with high probability, the perceived marginal cost of provincial borrowing approaches zero, sharply weakening market discipline and raising the incentive for debt-financed expenditure. The effect is large but bounded, since Proposition A.10 shows that under the linear-quadratic specification equilibrium spending converges to the finite aggregate satiation level of the actors' benefit functions rather than diverging. In terms of the common-pool model, a high φ is a direct reduction in θ_i, since it removes even the fraction of the cost the province would otherwise bear. In Argentina, where central assistance to provinces in fiscal

distress has been recurrent enough to shape expectations of rescue (Tommasi et al., 2001; Bordo et al., 2013), this mechanism may amplify the consolidated deficit beyond what the isolated behavior of each level of government would produce. Bordo et al. (2013) compared historical federations and found that the probability of subnational default and central rescue is a direct function of federal design, with broad revenue sharing and the absence of an explicit no-rescue rule generating recurrent cycles of subnational borrowing and central bailout of exactly the Argentine type, in contrast to federations that developed market discipline over subnational debt.

Beyond the bailout dynamic, the revenue-sharing arrangement generates a permanent distributive game between the national government and the provinces. The key asymmetry is that the transfer of resources to a province is visible and attributable, since a governor can present it as an achievement, while the cost of the national deficit that finances it is diffuse and deferred across all taxpayers and surfaces only when debt becomes unsustainable or inflation accelerates. Gibson and Calvo (2000) documented that provinces with disproportionate congressional weight, typically the least populous but electorally overrepresented, received significantly higher per capita transfers, a pattern consistent with the theory of minimum winning coalitions of Riker (1962), in which governments purchase support through fiscal transfers and pivotal actors extract disproportionate rents. Porto and Sanguinetti (2001) found for Argentina that per capita intergovernmental transfers are positively associated with provincial overrepresentation in Congress, so that the less populous provinces receive disproportionately large transfers while the most populous ones are underrepresented in the allocation. This pattern is the equilibrium outcome of the coparticipation game rather than a reflection of equity considerations, and it is a further illustration of the general result that the observed allocation satisfies the political constraints of the pivotal actors rather than any social welfare function.

The institutional interpretation can be made more precise using Argentine-specific research. Tommasi et al. (2001) emphasize that the persistence of the coparticipation and transfer system reflects bargaining incentives and the weak credibility of intergovernmental commitments, not only a technical failure to design a better formula. Spiller and Tommasi (2003) locate the underlying policy problem in the difficulty of sustaining intertemporal bargains across political actors. These findings offer a plausible institutional foundation for treating bailout expectations and θ_i as persistent but potentially reformable parameters. Importantly, a descriptive correlation between revenue sharing and deficits does not establish that transfers alone caused fiscal

deterioration; the model requires a claim about incentives, enforcement and their joint impact on financing choices.

6. Mechanism III: Inflation as Redistributive Technology

The most distinctive element of the framework is the treatment of inflation not as a symptom but as a political technology for distributing the fiscal cost, formalized in the financing block through condition (12). Inflation permits financing, dilution, and redistribution without an explicit vote on an equivalent tax, which is why it can be politically functional even when it is macroeconomically destructive. Cukierman et al. (1992) argued that polities with greater political fragmentation and institutional instability rely more heavily on seigniorage, because where conventional taxation is politically resisted, widely evaded, or weakly enforced, the inflation tax emerges as the instrument of least short-run political cost. In the model this corresponds to a high C_T' and a low λ, the two parameters that condition (12) shows push the optimum toward inflation. Unlike the income or consumption tax, which generates visible and immediate opposition, the inflation tax is less visible and operates automatically on holders of non-indexed nominal balances, although its incidence varies with the composition of asset holdings and the extent of indexation. The inflation tax on real money balances should also be distinguished from seigniorage, the revenue from money creation: the two coincide only under specific conditions, such as a stationary demand for real balances. Aizenman and Jinjarak (2009) show that the easy-to-collect tax bases of developing countries include tariffs and seigniorage, and document how economic integration is associated with a shift toward conventional tax instruments, which indicates that seigniorage is a structural element of the fiscal architecture of certain institutional equilibria rather than an emergency device.

The distributive incidence sharpens the argument. Erosa and Ventura (2002) demonstrated that the inflation tax is regressive, since lower-income households hold a larger share of their wealth in non-indexed cash and deposits while higher-income households hold real assets, foreign currency, and indexed instruments. This creates an apparent paradox for the political economy of populism, since governments presenting themselves as defenders of popular sectors employ a mechanism that harms those sectors regressively. The resolution has two dimensions. In the short run, emission-financed public spending generates visible employment and consumption for popular sectors while the inflationary cost is deferred and dispersed. Cognitively, the inflation tax is less visible and less institutionally attributable than conventional taxation, so

beneficiaries associate their welfare with the government while those harmed by inflation perceive the deterioration as a diffuse phenomenon.[7]

Desai et al. (2003) provide evidence consistent with this dynamic, showing that the inflationary effect of democracy depends on the degree of inequality. A visibility argument completes the logic: electorally oriented governments favor instruments that maximize the visibility of benefits and minimize the visibility of costs. Direct public spending satisfies the first condition better than a tax cut, and inflation satisfies the second better than direct taxation, so the combination of visible spending and invisible inflationary financing becomes the dominant strategy in systems with short horizons and limited transparency over the incidence of policy costs. A further channel is the liquidation of real debt through the erosion of nominal liabilities. When the state accumulates debt denominated in domestic currency, inflation reduces its real value and operates as a disguised restructuring that transfers wealth from creditors to the state. Reinhart and Sbrancia (2015) analyzed this financial-repression mechanism and documented its quantitative weight in the postwar reduction of advanced-economy public debt through negative real interest rates. Aizenman and Marion (2011) similarly analyze the incentive to use inflation to erode the real burden of nominal public debt. In Argentina the liquidation channel operates with greater intensity given the extent of informal dollarization, and it was especially salient in the episodes of abrupt devaluation in which the forced conversion of dollar contracts combined with accelerating inflation to produce massive wealth transfers from nominal creditors to debtors, including the state itself.[8]

The redistributive reading must nonetheless incorporate the dynamic limit already embedded in the seigniorage function $\sigma(\pi_t, \Theta_t)$. Seigniorage has a technical ceiling beyond which faster inflation reduces rather than raises the real resources available to the government, corresponding to the seigniorage-maximizing inflation rate in the framework of Cagan (1956), the point at which the marginal seigniorage yield of inflation falls to zero. That point is a feasibility boundary rather than a candidate optimum, since the first-order condition (12) can hold only where the marginal yield is strictly positive, so no interior financing equilibrium lies on the descending branch. Explosive dynamics arise instead when the required residual financing exceeds the maximum that taxation and seigniorage can jointly deliver, at which moment the interior

[7] In the notation of Section 3, this incidence helps explain why the political weight λ on inflation can remain low: the groups that bear most of the inflation tax are those least able to raise its political cost.

[8] In the notation of Section 3, inflationary liquidation lowers the real value of inherited nominal debt, the left-hand side of (3), and therefore the present value of the surpluses and seigniorage that must be raised to satisfy the intertemporal constraint.

solution ceases to exist and the government attempts to sustain spending through accelerating emission while money demand collapses faster than the monetary base expands. Kiguel and Liviatan (1992) analyzed the dynamics and eventual unraveling of exchange-rate-based stabilizations in chronic-inflation economies. In the present framework a sufficiently severe loss of credibility is represented instead as the disappearance of the interior financing equilibrium once the feasibility boundary is crossed, and Proposition A.7 states the critical credibility level below which a given financing requirement becomes infeasible. The endgame typically forces the accumulation of remunerated central bank liabilities to sterilize emission, and those quasi-fiscal liabilities become fiscal at the moment of adjustment, which is the second-round crisis mechanism identified by Burnside et al. (2001) in their analysis of prospective deficits. The inflation instrument, in other words, is bounded, and once the bound binds the redistributive technology turns explosive.

7. Mechanism IV: Credibility, Expectations, and Path Dependence

The fourth mechanism explains why the equilibrium persists, and it is formalized in the law of motion (13) and the interest-rate equation (14). Fiscal dominance becomes self-sustaining because agents anticipate that the state will again resort to inflationary or inconsistent financing. That expectation raises the risk premium through (14), reduces the demand for money and hence the marginal seigniorage yield $\sigma_{\pi}(\pi_t, \Theta_t)$, shortens contractual horizons, and weakens the effectiveness of any new program before it can take hold. Kydland and Prescott (1977) formulated the general proposition that discretionary policy is time-inconsistent, so that a low-inflation outcome requires rules that function as commitment devices rather than promises that agents expect to be broken. In the dynamic setting of Section 3, low credibility is not merely a consequence of fiscal dominance but one of the mechanisms through which fiscal dominance reproduces itself, since the anticipation of deviation is precisely what keeps the credibility stock Θ_t low and thereby keeps the interest-growth differential wide and the debt dynamics adverse.

Path dependence in the sense of North (1990) operates through the organizations that institutions generate: those organizations adapt to the existing framework, develop capacities specific to it, and therefore invest in the reproduction of the existing institutions even when these are inefficient. In the Argentine case the agents that have adapted their strategies to the regime of fiscal dominance, including unions negotiating indexed wages, firms setting prices with an inflation-cover margin, and provincial governments planning spending around a predictable path of shared revenue, have strong incentives to resist reforms that would alter the

regime, not out of irrationality but because their organizational investments are regime-specific and would lose value under an alternative arrangement. In the terms of Acemoglu and Robinson (2008), reviewed in Section 2.4, groups that hold power under the existing regime can block reforms that would weaken their position even when those reforms would raise aggregate welfare.

A low-quality institutional equilibrium can also be sustained by the rationality of the very actors who would seem to have the greatest interest in reform, a possibility consistent with the endogenous-institutions logic of Aghion et al. (2004), in which the rules that govern reform are themselves chosen by those whom reform would affect. In an environment of weak formal institutions, agents seek informal protection through private contracts, dollarized assets, and political connections, which partially insulate them from the costs of the equilibrium and thereby reduce their willingness to invest in institutional change. The actors with the greatest capacity to press for reform, namely high-income sectors with access to foreign-currency assets and firms able to relocate operations, are precisely those most insulated from the inflationary cost, while the sectors most harmed by high inflation lack the organizational resources to drive reform. The result is a self-reinforcing trap in which the distribution of insulation across actors mirrors and sustains the distribution of political voice, and in which the reform term $\eta \cdot R_t$ in the credibility equation remains close to zero because no sufficiently powerful actor is willing to supply it. Acemoglu and Robinson (2012) generalized the point by arguing that transitions from suboptimal to superior institutional equilibria require changes in the distribution of political power that alter who holds veto authority over the rules of the game, which is precisely the change that the Conjecture identifies as the condition for a durable regime switch.

8. Argentina: Historical Mechanisms and Descriptive Evidence

Argentina's macroeconomic record provides distinct opportunities to examine the mechanisms, but the exercise is not an econometric test. The analytical aim is to trace whether shifts in fiscal balances, provincial financing, monetary accommodation and credibility are consistent with the conditional predictions developed in Sections 2 and 3. Three historical moments illustrate the change in instruments, and a fourth subsection provides quantitative reference points and highlights an important recent departure. Table 1 maps the principal historical episodes onto the model. Tables 2 and 3 report selected fiscal and inflation indicators from published institutional sources; these are descriptive observations, not estimates of structural parameters or a substitute for a full historical data set.

Table 1. *Selected Argentine macroeconomic regimes and the institutional mechanisms examined in the model*

Period	Regime	Fiscal mechanism	Monetary / currency mechanism	Equilibrium implication
1975–1991	Chronic inflation / hyperinflation	Fiscal imbalance and delayed adjustment	Seigniorage, money-demand collapse	Credibility collapse
1991–2001	Convertibility	Fiscal fragility under a monetary rule	External anchor, suppressed inflation instrument	Rule without fiscal consolidation
2002–2023	Post-convertibility discretion	Fiscal and quasi-fiscal dominance	Monetary financing, controls, remunerated liabilities	Recurrent inflation; credibility varied by subperiod

Notes: The periods are stylized, and the model's institutional parameters are not assumed to be constant across or within them. The 2002–2023 period includes markedly different subperiods, beginning with a phase of primary surpluses. The fiscal adjustment of 2024–2025 is discussed in Section 8.4.

8.1 Inflationary regime and credibility collapse

The first moment runs from the mid-1970s to the end of the 1980s, a period of chronic inflation culminating in hyperinflation and the collapse of money demand. The populist cycle described by Dornbusch and Edwards (1991), Sachs (1989), and Cardoso and Helwege (1991) is legible in the sequence of expansion, payments tension, price and exchange controls, and eventual collapse. In the language of the model, this sequence is consistent with a low political discount factor β, a low internalized cost share θ_i associated with fiscal fragmentation, and a low political weight λ on inflation; on this interpretation, which is not a measurement of those parameters, the government relied increasingly on the inflation instrument as it approached the seigniorage boundary. The hyperinflation at the end of the decade can be read as the resolution of a fiscal war of attrition that had opened years earlier, in the sense of Alesina and Drazen (1991). The unraveling of the regime is consistent with the dynamics analyzed by Kiguel and Liviatan (1992); in the present model it is represented by the loss of feasibility of the interior financing equilibrium together with a collapse in the credibility stock Θ_t.

Historical price data provide an observable measure of the collapse: INDEC's historical consumer price index records December-to-December inflation of 4,923.6% in 1989 and 1,343.9% in 1990, followed by 84.0% in 1991 (INDEC, n.d.). These figures refer to the consumer price index for Greater Buenos Aires, the official index at the time, and are not strictly comparable with the national CPI used for 2020–2025 in Table 3. These observations do not by themselves identify the political equilibrium or isolate seigniorage demand from currency substitution, but they establish the magnitude and persistence of nominal instability around the regime break. The BCRA's 1989 annual report also explicitly identified chronic inflationary

financing of public deficits and the endogenous expansionary effects of remunerated monetary liabilities as elements of the inflation process (BCRA, 1990). The latter is especially relevant to the model's connection between financing needs and the changing balance sheet of the monetary authority.

8.2 Convertibility as a constrained stabilization

The second moment covers the convertibility decade of the 1990s. Monetary stabilization was initially successful, and the early phase included periods of stronger fiscal performance. However, fiscal fragilities subsequently re-emerged beneath the nominal anchor. This is consistent with the conditional argument of Proposition 3, which holds that stabilizations based primarily on a monetary rule may be vulnerable if credible fiscal and intergovernmental commitments do not endure. The convertibility arrangement sharply restricted inflationary finance but did not, by itself, establish a permanent alignment of provincial revenue and spending responsibility or eliminate subnational borrowing incentives. The available data are more nuanced than the claim of an unbroken decade of deficit: the IMF's evaluation reports a federal fiscal balance of +0.62% of GDP in 1992, followed by −1.93% in 1996 and −3.24% in 2001, while the consolidated provincial balance deteriorated from −0.29% to −2.32% of GDP between 1992 and 2001 (IMF Independent Evaluation Office, 2004, Table A3.5). The shift indicates that the fiscal pressure was historically variable, even as the regime's financing vulnerabilities accumulated. The eventual crisis cannot be attributed uniquely to federal bargaining; the role of foreign-currency debt, shocks, the exchange-rate regime and the sudden stop must also be considered.

8.3 Post-convertibility discretion

The third moment covers the post-convertibility period through 2023, which combined an initial phase of primary surpluses with a later recurrence of fiscal imbalances, high inflation, exchange controls, monetary financing and large remunerated central-bank liabilities. These instruments should not be treated as interchangeable: direct transfers to the Treasury, purchases of government debt and sterilization liabilities operate through different accounting channels and have different implications for inflation and consolidated public-sector risk. Nevertheless, the 2023 BCRA report describes both direct and indirect monetary financing in the context of constrained Treasury market access (BCRA, 2024). The Argentine Congressional Budget Office reports net direct BCRA financing to the Treasury of ARS 1.698 trillion in 2023, consisting of ARS 1.298 trillion in temporary advances and ARS 0.400 trillion in profit transfers (OPC, 2024).

Both components are flows of direct financing to the Treasury; they are reported separately from, and are not added to, the stock of remunerated central-bank liabilities used for sterilization. This is direct institutional evidence of monetary-fiscal interaction, although it cannot quantify the causal contribution of that financing to inflation without a separate monetary model. The episode is consistent with the political-economy mechanism, but a claim that unchanged parameters mechanically generated identical outcomes throughout 2002–2023 would disregard important fiscal and policy reversals within the period.

8.4 Quantitative benchmarks, counterevidence and identification limits

Table 2 reports selected federal and provincial fiscal balances during convertibility. The shift from an early federal surplus to substantial deficits by 2001, together with deteriorating provincial finances, is consistent with the common-pool and soft-budget mechanisms. The balances represent different levels of government and should not be summed without reconciling transfers and coverage; they are descriptive, not causal estimates.

Table 2. *Selected federal and provincial fiscal balances under convertibility (% of GDP)*

Year	Federal government fiscal balance	Consolidated provincial governments fiscal balance
1992	+0.62	−0.29
1996	−1.93	−0.44
2001	−3.24	−2.32

Source: IMF Independent Evaluation Office (2004), Appendix Table A3.5, reproduced as reported by the IEO. Selected years; overall balances, percentage of GDP.

Table 3 juxtaposes the national non-financial public-sector primary and overall fiscal balances with December-to-December consumer-price inflation for 2020–2025. It uses the BCRA's historical fiscal compilation for 2020–2024, drawing on Ministry of Economy and INDEC data, the Ministry of Economy's annual results for the national public sector for 2025, and the national CPI series published by INDEC. The juxtaposition is informative about the co-movement of fiscal and nominal outcomes but does not imply that contemporaneous primary balances determine contemporaneous annual inflation one-for-one. Monetary financing, expectations, exchange-rate changes, shocks, lag structures and the composition of public liabilities all matter.

Table 3. *Argentina: fiscal outcomes and year-end CPI inflation, 2020–2025*

Year	Primary balance (% GDP)	Overall balance (% GDP)	December CPI, y/y (%)
2020	−6.4	−8.4	36.1
2021	−3.0	−4.5	50.9
2022	−2.0	−3.8	94.8
2023	−2.7	−4.4	211.4
2024	+1.8	+0.3	117.8
2025	+1.4	+0.2	31.5

Sources: BCRA (2025), Informe Anual al Congreso 2024, Chart 3.8, for the 2020–2024 fiscal figures; Ministerio de Economía (2026) for the 2025 fiscal figures; INDEC (2021, 2022, 2023, 2024, 2025, 2026), December CPI releases. Notes: 2021 primary balance excludes income from the IMF SDR allocation as indicated by BCRA; CPI figures are December-on-December changes, not annual averages; fiscal figures cover the national public sector, not consolidated provinces; the 2025 figures are the Ministry of Economy's cash-basis annual results, and their comparability with the BCRA compilation for earlier years should be checked against the final official series.

The late-sample observation is especially important for interpretation. In 2024 the national primary fiscal balance moved from −2.7% to +1.8% of GDP and the overall balance from −4.4% to +0.3% of GDP; December-on-December inflation declined from 211.4% in 2023 to 117.8% in 2024 (BCRA, 2025; INDEC, 2024, 2025). The fiscal adjustment initiated in 2024 continued in 2025: the national public sector recorded primary and overall surpluses of 1.4% and 0.2% of GDP (Ministerio de Economía, 2026), while December-to-December inflation declined further to 31.5% (INDEC, 2026). This development challenges any interpretation of fiscal dominance as an immutable annual outcome, and it constitutes potential counterevidence to the historical pattern rather than a confirmation of the model. It does not, by itself, identify a permanent shift in the underlying institutional parameters θ_i, φ, λ or R_t, or establish the durability of the stabilization regime; two years of fiscal outcomes cannot establish whether the observed break marks a lasting change in those parameters.

There are at least four limits to this evidence. First, the tables aggregate different entities and time horizons and cannot identify the unobserved fiscal-cost internalization parameter θ_i. Second, the fiscal and inflation series provide co-movement, not exogenous variation that would isolate monetary-fiscal causation. Third, the joint operation of federal transfers, central-bank instruments, external borrowing and shocks prevents a clean attribution to any one mechanism. Fourth, policy regimes and data comparability differ across decades. Accordingly, the evidence is best read as a disciplined historical plausibility check. A subsequent research agenda could construct a longer consolidated public-finance panel and estimate dynamic implications using carefully defined institutional and monetary indicators.

9. Comparative Institutional Benchmarking

The comparison provides a qualitative institutional benchmark, not causal identification or quantitative calibration. Argentina, Chile and Canada differ in monetary regimes, resource exposure, federal structure, historical starting conditions and external financing. They therefore cannot be treated as matched cases. The narrower claim is that institutions that make fiscal commitments more credible and strengthen the internalization of fiscal costs may alter the incentives represented by θ_i, λ and the reform process R_t. Chile's fiscal-rule experience illustrates the role of public commitments and technical procedures, while Canada illustrates a federation in which provincial borrowing has been disciplined by markets rather than by expectations of central rescue. Canada is used as a qualitative institutional contrast, not as a statistical control or counterfactual. These contrasts motivate hypotheses about institutional design but cannot, by themselves, establish which mechanism explains Argentina's outcomes.

Chile has used a structural-balance framework since 2001, and independent expert committees supply the estimates of trend output and of the long-run reference copper price used in the structural-revenue calculation (DIPRES, n.d.-a, n.d.-b). Frankel (2011) argued that the effectiveness of the rule rests less on the specific methodology of the structural calculation than on these institutional features and on a record of compliance that reinforces credibility. Institutional oversight was strengthened after that analysis: a Fiscal Advisory Council was established in 2013 and was replaced in 2019 by the Fiscal Autonomous Council, created by law (DIPRES, n.d.-a; Consejo Fiscal Autónomo, 2019). These arrangements should be distinguished from the evolving legal basis, targets and compliance mechanisms of the rule itself. The rule modifies the parameters of the political game by raising the cost of departing from the structural spending path, which in the model corresponds to raising the effective political cost of spending and thereby lifting θ_i toward one. Besley and Persson (2011) generalized the point by showing that robust fiscal institutions do not arise spontaneously in equilibrium but require deliberate political investment in mechanisms that align the incentives of powerful actors with fiscal sustainability, an investment that is costly in the short run and diffuse in its long-run benefits and therefore occurs only under specific conditions. On the federal dimension, Rodden (2006) and the historical comparison in Bordo et al. (2013) show that federations with a credible no-bailout norm, of which Canada is a salient case in the latter comparison, developed market discipline over subnational debt, whereas broad revenue sharing without an explicit no-rescue rule generated recurrent cycles of subnational borrowing and central rescue of the kind observed

in Argentina, which in equation (15) is the difference between a perceived bailout probability near zero and one near unity.

The relevant lesson is not that differences in institutions alone explain all macroeconomic divergences, but that any account of repeated fiscal-financing difficulties must examine whether fiscal, monetary and intergovernmental commitments can be sustained. Argentina's experience is compatible with this interpretation, while the fiscal turnaround of 2024–2025 shows the importance of allowing for regime change and the possibility that institutional parameters can evolve. The comparison motivates a research program rather than providing decisive evidence. The analysis of Argentine fiscal federalism by Tommasi et al. (2001), and the intertemporal transactions approach of Spiller and Tommasi (2003), provide more immediate country-specific foundations for interpreting the incentive structure than a simple contrast across national outcomes.

10. Institutional Implications: Changing the Parameters of the Game

The framework carries a cautious institutional implication that should not be read as a government program. Stabilization requires institutional reforms that alter the payoff structure of fiscal decisions rather than a better selection of players operating under an unchanged set of rules. In the notation of the model, sustainable stabilization requires raising the internalized cost share θ_i, raising the political weight λ on inflation through an effectively independent monetary authority, and supplying a durable reform term $\eta \cdot R_t$ in the credibility equation. The escape from the equilibrium does not follow from isolated improvements in policy by better-informed actors. As discussed in Section 7, such transitions require changes in who holds veto authority over the rules of the game (Acemoglu & Robinson, 2012), which is the condition represented by the Conjecture in Section 3.5.

Concretely, the analysis points toward a fiscal architecture that raises the political cost of the deficit through rules operating as commitment devices, a federal design that aligns spending responsibility with tax responsibility and hardens the subnational budget constraint so that the perceived bailout probability in equation (15) falls toward zero, a monetary authority whose independence is effective rather than merely formal so that the weight λ is credibly high, and enforcement mechanisms that make the violation of commitments costly for all actors rather than only for incoming governments. Rodrik (1996) noted that successful reforms tend to combine a crisis that exposes the cost of the status quo, political leadership able to absorb transition costs, and institutions that permit credible commitments over the future distribution

of the reform's benefits. Haggard and Kaufman (1995) added that the durability of macroeconomic reform depends on the consolidation of supporting coalitions, since reforms whose benefits are diffuse and whose costs are concentrated in organized groups tend to be reversed, a conclusion that follows in the model from the observation that the reform term $\eta \cdot R_t$ must be defended period after period against actors who benefit from its removal. The asymmetry explains why disinflation attracts initial support, because the cost of inflation is visible, yet encounters resistance in the consolidation phase, when it requires spending reductions that affect specific organized groups. Sustainable stabilization is therefore achieved not by choosing better players but by changing the rules of the game.

11. Conclusion

Argentina's recurrent fiscal-dominance episodes are plausibly understood as a self-reinforcing but historically variable institutional configuration, rather than simply as repeated technical policy mistakes. The framework identifies a specific interaction among four mechanisms. Common-pool incentives and soft subnational budget constraints may push politically selected spending above the social benchmark; fiscal financing then allocates a given requirement across taxation, debt and seigniorage; and credibility losses affect both future borrowing costs and the monetary financing margin. This interaction is the principal analytical contribution. It clarifies how the same set of incentives can generate pressures in fiscal decisions and subsequently affect the nominal stability of the financing regime. The formal results remain conditional on the maintained assumptions and do not amount to an estimated equilibrium for Argentina.

The historical evidence is consistent with important parts of the mechanism: hyperinflation in 1989–1990, deterioration in federal and provincial fiscal balances before 2001, and direct and indirect monetary financing in the recent inflationary episode provide distinct descriptive anchors. The fiscal adjustment of 2024–2025, however, demonstrates that these outcomes are not inevitable in each year and constitutes potential counterevidence to the historical pattern, and that the persistence of the underlying institutional configuration requires careful evaluation over time. The tables and sources presented here cannot disentangle the causal contributions of fiscal bargaining, external shocks, exchange-rate policy, financing constraints and credibility. The four mechanisms are therefore not causally established by the evidence presented; they articulate a conditional explanation with which that evidence is congruent. The principal implication is therefore a research hypothesis with institutional relevance: more durable stabilization should be associated with reforms that strengthen fiscal cost internalization,

improve the enforcement of intergovernmental commitments and make monetary-fiscal financing rules credible. Long-run evidence and explicit identification strategies remain necessary to assess the relative importance of each mechanism.

Appendix A. Derivations and Proofs

A.1 Notation and maintained assumptions

Notation follows the text. Throughout: $v_i' > 0$, $v_i'' < 0$, $C' > 0$, $C'' > 0$, $C_T' > 0$ and $C_T'' > 0$, with $\theta_i \in (0,1)$; $\sigma(\cdot, \Theta)$ is defined on the interval from zero to $\pi^{max}(\Theta)$ with $\sigma_\pi > 0$ for $0 \leq \pi < \pi^{max}(\Theta)$, $\sigma_{\pi\pi} < 0$, $\sigma_\Theta > 0$, $\sigma_{\pi\Theta} > 0$ and $\sigma_\pi(\pi^{max}(\Theta), \Theta) = 0$; $\beta, \varrho \in (0,1)$ and $\lambda, \mu, \alpha, \delta, \eta, \varkappa > 0$; a, h, c and τ, ω, χ appear only in the closed-form examples. The asterisk is reserved for the efficient aggregate G^*, an overbar denotes a steady-state value, r^f denotes the risk-free rate, and k and K denote the summation index and the finite horizon. We additionally assume the standard boundary conditions under which marginal benefits exceed perceived marginal costs at zero and fall below them for sufficiently large spending, ensuring an interior crossing.

A.2 The intertemporal budget constraint

Solving (1) at a constant real rate and iterating K times,

$$\begin{aligned} B_{t-1} &= (1+r)^{-1}\left[B_t + (T_t + S_t - G_t)\right] \\ B_{t-1} &= \textstyle\sum_{k=0}^{K}(1+r)^{-(k+1)}\,(T_{t+k} + S_{t+k} - G_{t+k}) + (1+r)^{-(K+1)}B_{t+K} \end{aligned} \qquad \text{(A.1)}$$

The transversality condition that the last term vanish as K grows yields (3). Dividing (1) by output with $Y_t = (1 + \gamma_t) \cdot Y_{t-1}$, and writing pb_t for the primary balance relative to output,

$$\Delta b_t = \frac{r_t - \gamma_t}{1+\gamma_t}\, b_{t-1} - pb_t - s_t \qquad \text{(A.2)}$$

of which (2) is the first-order approximation.

A.3 The common-pool game

Payoffs $U_i = v_i(g_i) - \theta_i \cdot C(G)$ are strictly concave in g_i, since $v_i'' - \theta_i \cdot C'' < 0$. Letting $\psi_i(G)$ solve (6) for a given aggregate,

$$\begin{gathered} v_i'(\psi_i(G)) = \theta_i\, C'(G), \qquad \psi_i'(G) = \frac{\theta_i\, C''(G)}{v_i''(\psi_i(G))} < 0 \\ \textstyle\sum_{i=1}^{n} \psi_i(G) = G \end{gathered} \qquad \text{(A.3)}$$

Lemma A.1. Under the maintained boundary and interiority conditions, the Nash equilibrium exists and is unique. *Proof.* An aggregate is an equilibrium if and only if the second line of (A.3) holds; its left-hand side is strictly decreasing in G and its right-hand side strictly increasing, so the crossing is unique. The same argument applied to (7) gives a unique G^*.

Proposition A.1. If $\theta_i < 1$ for every i, then $G^N > G^*$. *Proof.* Suppose $G^N \le G^*$. Then $C'(G^N) \le C'(G^*)$, so $v_i'(g_i^N) = \theta_i \cdot C'(G^N) < C'(G^*) = v_i'(g_i^*)$, and $v_i'' < 0$ gives $g_i^N > g_i^*$ for every i, whence $G^N > G^*$, a contradiction. In the symmetric case, implicit differentiation of $v'(G/n) = \theta \cdot C'(G)$ gives

$$\frac{dG^N}{d\theta} = \frac{C'(G^N)}{v''(G^N/n)/n - \theta C''(G^N)} < 0 \qquad \text{(A.4)}$$

The comparative static in n requires more structure. Let

$$v_i(g_i) = a\,g_i - \frac{h}{2}g_i^2, \qquad C(G) = \frac{c}{2}G^2, \qquad \theta_i = \frac{1}{n}$$
$$G^N = \frac{n\,a}{h + c} \qquad \text{and} \qquad G^* = \frac{n\,a}{h + c\,n} \qquad \text{(A.5)}$$

with the aggregate cost function held fixed as n varies, so that n indexes fragmentation rather than size. *Proposition A.2.* The wedge is strictly positive for $n > 1$ and strictly increasing in n:

$$G^N - G^* = \frac{a\,c\,n\,(n-1)}{(h+c)(h+c\,n)} > 0$$
$$\frac{\partial\,(G^N - G^*)}{\partial n} = \frac{a\,c\,(2hn - h + c\,n^2)}{(h+c)(h+c\,n)^2} > 0 \qquad \text{(A.6)}$$

Proof. Subtract the two expressions in (A.5). Differentiating $n(n-1)/(h + c \cdot n)$ gives the numerator $(2n-1)(h + c \cdot n) - c \cdot n(n-1) = 2hn - h + c \cdot n^2$, positive for $n \ge 1$.

A.4 The financing problem

Rearranging (1) gives $\Delta B_t = r_t \cdot B_{t-1} + G_t - T_t - S_t$, which is (10). The residual financing requirement is

$$F_t \;\equiv\; G_t + (1 + r_t)\,B_{t-1} - B_t \;=\; T_t + \sigma(\pi_t, \Theta_t) \qquad \text{(A.7)}$$

so B_t determines F_t one for one: debt is the intertemporal margin, not a free instrument. Stage one solves

$$\Phi(F_t; \Theta_t) = \min_{T_t \ge 0,\ \pi_t \in [0, \pi^{\max}(\Theta_t)]} \; C_T(T_t) + \lambda\,\pi_t^2$$
$$\text{subject to} \quad T_t + \sigma(\pi_t, \Theta_t) \;\ge\; F_t \qquad \text{(A.8)}$$

with first-order conditions

$$C_T'(T_t) = \xi_t \qquad \text{and} \qquad 2\,\lambda\,\pi_t = \xi_t\,\sigma_\pi(\pi_t, \Theta_t) \tag{A.9}$$

which are (11); eliminating ξ_t gives (12). *Lemma A.2.* Φ is increasing and convex in F_t, and

$$\Phi'(F_t;\Theta_t) = \xi_t > 0, \quad \Phi''(F_t;\Theta_t) \geq 0, \quad \Phi_\Theta = -\,\xi_t\,\sigma_\Theta < 0 \tag{A.10}$$

Proof. The set on which $T + \sigma(\pi, \Theta) \geq F_t$ is convex because σ is concave, and the objective is convex, so the value function is convex in F_t; because the objective is increasing in both financing instruments on the relevant domain, the inequality binds at the optimum, and the derivatives are envelope conditions. Under the local linear-quadratic specification, given by (A.11) below with $\chi = 0$, Φ is quadratic in F_t, as (A.12) shows, and therefore strictly convex. Since $\lambda > 0$ and $\xi_t > 0$, (A.9) requires $\sigma_\pi > 0$, so no interior optimum lies on the descending branch of the seigniorage curve: the peak is a feasibility boundary, not a candidate optimum. For a closed form let $C_T(T) = (\tau/2) \cdot T^2$ and

$$\sigma(\pi,\Theta) = \omega\,\Theta\,\pi - \frac{\chi}{2}\,\pi^2$$
$$\pi^{\max}(\Theta) = \frac{\omega\,\Theta}{\chi} \qquad \text{and} \qquad S^{\max}(\Theta) = \frac{\omega^2\Theta^2}{2\chi} \tag{A.11}$$

For the local interior comparative statics we use the first-order approximation obtained by setting $\chi = 0$; the full specification with $\chi > 0$ is retained for the feasibility analysis. Writing $Q(\Theta_t) \equiv 2\lambda + \tau \cdot \omega^2 \cdot \Theta_t^2$,

$$T_t = \frac{2\lambda\,F_t}{Q(\Theta_t)} \qquad \pi_t = \frac{\tau\,\omega\,\Theta_t\,F_t}{Q(\Theta_t)} \qquad S_t = \frac{\tau\,\omega^2\Theta_t^2\,F_t}{Q(\Theta_t)}$$
$$\Phi(F_t;\Theta_t) = \frac{\tau\,\lambda\,F_t^2}{Q(\Theta_t)} \tag{A.12}$$

Proposition A.3 (Proposition 2). For $F_t \geq 0$ and $\Theta_t \in (0,1]$, the interior solution (A.12) satisfies $T_t \geq 0$ and $\pi_t \geq 0$; it is valid as an approximation to the full specification only while π_t remains below $\pi^{\max}(\Theta_t)$, and outside that region the feasibility analysis of Proposition A.7 applies. Within that region, optimal inflation rises with the financing requirement and with the political cost of taxation, and falls with the political weight on inflation:

$$\frac{\partial\pi_t}{\partial F_t} = \frac{\tau\,\omega\,\Theta_t}{Q} > 0, \qquad \frac{\partial\pi_t}{\partial\lambda} = -\,\frac{2\,\tau\,\omega\,\Theta_t F_t}{Q^2} < 0,$$
$$\frac{\partial\pi_t}{\partial\tau} = \frac{2\,\lambda\,\omega\,\Theta_t F_t}{Q^2} > 0 \tag{A.13}$$

Proposition A.4. For $B_{t-1} \geq 0$ and an interior solution, since $r_t = r^f + \varkappa(1 - \Theta_t)$ and F_t contains $r_t \cdot B_{t-1}$, the total effect of credibility on inflation is

$$\frac{d\pi_t}{d\Theta_t} = \frac{\tau\,\omega}{Q^2}\left[F_t\left(2\lambda - \tau\,\omega^2\Theta_t^2\right) - \kappa\,B_{t-1}\,\Theta_t\,Q(\Theta_t)\right] \tag{A.14}$$

For $F_t \geq 0$ and $B_{t-1} \geq 0$, this derivative is non-positive whenever $\tau \cdot \omega^2 \cdot \Theta_t^2 \geq 2\lambda$. It is strictly negative if either $\tau \cdot \omega^2 \cdot \Theta_t^2 > 2\lambda$ with $F_t > 0$, or $B_{t-1} > 0$ (given $\varkappa > 0$ and $\Theta_t > 0$). At the boundary $\tau \cdot \omega^2 \cdot \Theta_t^2 = 2\lambda$ with $B_{t-1} = 0$, the derivative may be zero. Holding F_t fixed the sign is ambiguous, since lower credibility also lowers the marginal yield of the inflation tax; the debt-service channel is the unambiguous one. Stage two maximizes the discounted sum of $V(G_t) - \Phi(F_t; \Theta_t) - \mu \cdot D_t$ over the debt path subject to (A.7), taking the anticipated paths of credibility and of future borrowing rates as given. Since a unit increase in B_t lowers F_t by one and raises F_{t+1} by $(1 + r_{t+1})$, the conditional Euler condition is

$$\Phi'(F_t;\Theta_t) = \beta\,(1 + r_{t+1})\,\Phi'(F_{t+1};\Theta_{t+1}), \qquad \text{i.e.} \quad \xi_t = \beta\,(1 + r_{t+1})\,\xi_{t+1} \tag{A.15}$$

Proposition A.5. Under the local linear-quadratic specification, if $\beta(1 + r) < 1$ and credibility is constant, so that r is constant, then $F_{t+1} > F_t$. *Proof.* (A.15) gives $\xi_{t+1} > \xi_t$, and by (A.12) Φ is quadratic in F_t, so Φ' is strictly increasing. This is the deficit-bias property Section 4 invokes. Because (A.15) takes the anticipated credibility path as given, it is a conditional rather than a fully dynamic optimality condition: a fully integrated problem would add a co-state for Θ capturing the effect of current borrowing on future credibility through inflation and sovereign risk.

Proposition A.6 (local commitment wedge). Conditions (A.9) describe a discretionary policymaker that takes next-period credibility as given. For an interior local comparison evaluated at a common reference allocation, a policymaker that internalizes the marginal effect of current inflation on future credibility, which is $-\alpha$ by (13), faces an additional future political cost and replaces the second condition in (A.9) by

$$\begin{aligned} 2\,\lambda\,\pi_t + \Xi_t &= \xi_t\,\sigma_\pi(\pi_t,\Theta_t) \\ \Xi_t &\equiv \beta\,\alpha\left[\kappa\,B_t\,\Phi'(F_{t+1};\Theta_{t+1}) - \Phi_\Theta(F_{t+1};\Theta_{t+1})\right] > 0 \end{aligned} \tag{A.16}$$

Since $\Phi' > 0$ and $\Phi_\Theta < 0$ by (A.10), Ξ_t is positive whenever $\varkappa \cdot B_t \cdot \Phi' - \Phi_\Theta > 0$, which holds in particular for $B_t \geq 0$. When the bracketed term is positive, Ξ_t raises the marginal cost of inflation relative to the discretionary condition, so that, if the net marginal cost of inflation is increasing in π_t at the reference allocation, the rate satisfying (A.16) lies below the rate satisfying (A.9). The expression is a local commitment wedge evaluated without recomputing the full

equilibrium, not a comparison of Markov-perfect equilibria; for given values of Φ' and Φ_Θ, Ξ_t is proportional to α and β and vanishes as β approaches zero.

Proposition A.7 (financing feasibility). With an exogenous tax ceiling T^{max}_t, the largest requirement financeable through taxation and seigniorage at credibility Θ_t is $F^{max}_t(\Theta_t) = T^{max}_t + S^{max}(\Theta_t)$. If F_t exceeds this bound, no feasible tax–seigniorage allocation exists under the stated ceilings. Adjustment must then reduce the financing requirement, relax a constraint or occur through mechanisms outside the interior problem, such as expenditure cuts, additional borrowing where available, restructuring or revaluation of nominal liabilities. For $F_t > T^{max}_t$, the critical credibility level that solves $F_t = F^{max}_t(\Theta_t)$ is given by (A.17):

$$\Theta_t^c = \frac{1}{\omega}\sqrt{2\chi\,(F_t - T_t^{\max})} \qquad \text{(A.17)}$$

If $F_t \leq T^{max}_t$, monetary financing is not required for feasibility and the corresponding threshold may be defined as zero; this is a statement about feasibility, not about the politically optimal mix, which in the interior may still include inflation. If the expression in (A.17) exceeds one, no Θ_t in [0,1] makes the requirement financeable through those two instruments alone. This threshold is derived from the full $\chi > 0$ seigniorage specification in (A.11), not from the local $\chi = 0$ approximation used for interior comparative statics. A fall in Θ_t can therefore render infeasible a requirement that was feasible one period earlier, with no change in fiscal policy.

A.5 Credibility dynamics

With inflation, default and institutional effort stationary, (13) has the steady-state candidate $\bar{\Theta} = (\eta\,\bar{R} - \alpha\,\bar{\pi} - \delta\,\bar{D})\,/\,(1-\rho)$, which is an interior steady state only when its numerator lies strictly between zero and $1 - \varrho$; if the numerator is non-positive, credibility converges to zero, and if it is at least $1 - \varrho$, credibility converges to the upper bound of one. Holding the debt ratio fixed,

$$\frac{d\Theta_{t+1}}{d\Theta_t} = \rho + \Lambda_t, \qquad \Lambda_t \equiv -\alpha\,\frac{d\pi_t}{d\Theta_t} \qquad \text{(A.18)}$$

Proposition A.8 (conditional scalar stability). Holding the debt ratio fixed, the scalar credibility map is locally stable around an interior steady state if and only if $|\varrho + \Lambda| < 1$, which in the economically relevant case $\Lambda \geq 0$, as under the condition of Proposition A.4, reduces to $\Lambda < 1 - \varrho$. This is a partial property of the credibility equation for a given debt ratio and does not establish stability of the joint debt–credibility system, which is addressed by Proposition A.9. If $\Theta_t = 0$ and $\eta \cdot R_t \leq \alpha \cdot \pi_t + \delta \cdot D_t$, the projection keeps credibility at zero, and zero remains absorbing for as long as this inequality persists; reaching any Θ_{t+1} requires

$$\eta R_t \;\geq\; \Theta_{t+1} - \rho\,\Theta_t + \alpha\,\pi_t + \delta\,D_t \qquad \text{(A.19)}$$

This is the quantitative counterpart of Proposition 3: at zero credibility a disinflation lowers $\alpha \cdot \pi_t$ but cannot by itself lift credibility while $\eta \cdot R_t$ remains at zero. Let pb(b, Θ), s(b, Θ) and π(b, Θ) denote the policy functions of the financing block, expressed as ratios to output where relevant, with all partial derivatives evaluated at the interior steady state. Linearizing (2) and (13) jointly around that point gives

$$J = \begin{pmatrix} 1 + r^f + \kappa(1-\bar{\Theta}) - \gamma - \dfrac{\partial(pb+s)}{\partial b} & -\kappa\,\bar{b} - \dfrac{\partial(pb+s)}{\partial \Theta} \\ -\alpha\,\dfrac{\partial \pi}{\partial b} & \rho + \Lambda \end{pmatrix} \qquad \text{(A.20)}$$

The off-diagonal elements of J are both negative only under explicit local sign restrictions: $\partial\pi/\partial b > 0$ and $\varkappa\bar{b} + \partial(pb + s)/\partial\Theta > 0$, with all derivatives evaluated at the interior steady state. These conditions are maintained assumptions of the local regime, not identities implied solely by non-negative debt or by a non-negative direct effect of credibility on seigniorage. In particular, a sufficiently negative response of the primary balance to credibility can overturn the sign of $J_{b\Theta}$. The stability statements below apply only where these restrictions hold. The joint system is locally stable if and only if both eigenvalues of J lie inside the unit circle, that is, if and only if the Jury–Schur conditions $1 - \text{tr } J + \det J > 0$, $1 + \text{tr } J + \det J > 0$ and $1 - \det J > 0$ hold. *Proposition A.9.* If $J_{\Theta\Theta} < 1$, $J_{bb} > 1$ and $J_{b\Theta} \cdot J_{\Theta b} > 0$, then $1 - \text{tr } J + \det J = (1 - J_{bb})(1 - J_{\Theta\Theta}) - J_{b\Theta} \cdot J_{\Theta b} < 0$, so J has a real eigenvalue above one and the configuration is locally unstable. Conversely, when $J_{\Theta\Theta} < 1$ and $J_{b\Theta} \cdot J_{\Theta b} > 0$, the first Jury–Schur condition requires $J_{bb} < 1$, that is,

$$\frac{\partial\,(pb_t + s_t)}{\partial b_{t-1}} \;>\; r^f + \kappa\,(1 - \bar{\Theta}) - \gamma \qquad \text{(A.21)}$$

Condition (A.21) is therefore necessary but not sufficient for local stability, since the other two Jury–Schur conditions must also hold; its right-hand side is increasing in the credibility deficit, so an economy that loses credibility raises the threshold it must clear.

A.6 Equilibrium concepts

The common-pool block is a Nash equilibrium in the strict sense, by Lemma A.1. The remaining blocks define a self-reinforcing institutional configuration: spending solves the common-pool game, the financing pair solves (A.8), the debt path satisfies the conditional Euler condition (A.15) and transversality, and credibility is a fixed point of (13), so that the composite map of A.3 to A.5 is stationary. *Remark A.1.* This is weaker than a subgame-perfect or Markov-perfect equilibrium, which would additionally require the strategy sets, payoffs, timing, information sets

and off-path beliefs of private agents. No result above depends on that structure. In particular, (A.15) is conditional on the anticipated credibility path, so the configuration combines a conditional financing optimum with an explicit credibility feedback rather than solving a fully specified dynamic political game.

A.7 The soft budget constraint

A province attaching probability φ to a central rescue internalizes only the fraction 1 − φ of the marginal interest cost of borrowing, so in reduced form its perceived marginal interest cost is (1 − φ) · r, which is (15), and its effective internalized share is θ_i multiplied by (1 − φ). *Proposition A.10.* Under (A.5) with $\theta_i = (1 - \varphi)/n$,

$$G^N(\varphi) = \frac{n\,a}{h + (1-\varphi)\,c} \qquad \frac{dG^N}{d\varphi} = \frac{n\,a\,c}{[h + (1-\varphi)\,c]^2} > 0$$
$$\lim_{\varphi \to 1} G^N = \frac{n\,a}{h} < \infty \tag{A.22}$$

Proof. From $a - h \cdot G/n = (1 - \varphi) \cdot c \cdot G/n$. Spending rises sharply as φ approaches one but converges to the finite bound $n \cdot a/h$, the aggregate satiation level of the benefit functions. Discipline weakens sharply; the equilibrium does not diverge.

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