

[Greed versus Fear: Optimal Time-Consistent Taxation with Default](#)

CFM-DP2026-25

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This paper studies optimal time-consistent distortionary taxation with default. The government taxes labor income or issues non-contingent debt to finance an exogenous stochastic stream of fiscal shocks. Debt can be repudiated subject to default costs. Optimal policy is characterized by two opposing incentives that capture the double lack of commitment to old tax policies and to repaying debt, respectively: an incentive to postpone taxes by issuing more debt for the future (“Greed”), and an incentive to tax more currently to avoid punishing default premia (“Fear”). A Generalized Euler Equation captures these forces and determines the optimal back-loading or front-loading of tax distortions. Even with small default risk, tax-smoothing and debt issuance are substantially limited when short-term debt is available. The same mechanisms operate in environments with long-term debt, but debt serves more as a fiscal absorber.