

# Dynamic Optimization of the Public Budget in the Presence of External Funds

By

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## **Abstract**

External funds in the form of foreign aid (external revenue) or capture (external spending) constitute important components of the government's budget constraint in many developing countries. We derive optimal public spending – and the resulting optimal deficit and debt – in an optimal control framework when the government seeks to maximize the utility of constituents in the presence of external funds that are contingent on public revenue and debt and that cannot be influenced directly by constituents. We find that in this context, a policy of running budget deficits and accumulating debt becomes optimal.

In simulations, we characterize the size and the path-dependency of the optimal deficit and debt.