Discussion of "A Lost Decade of Fiscal Misallocation" by Aoki, Fujiwara, Lin, Song and Wang

Discussant: Kaiji Chen
Emory University & ABFER

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Big Picture

Question: How does fiscal expansion affect **resource allocation**?

Core idea:

- Low interest rates $\rightarrow$ relaxed borrowing constraint
- $\rightarrow$ fiscal expansion ("easy borrowing")
- $\rightarrow$ **politically-driven allocation** of government investment
- $\rightarrow$ **misallocation + welfare loss**

Contribution Relative to Literature

Misallocation literature

- Hsieh-Klenow (2009)
- Song et al. (2011)
- Mostly private-sector distortions

Japan Lost Decade literature

- Caballero-Hoshi-Kashyap (2008), Peek-Rosengren (2005), Fukao-Kwon (2006)
- Japan's lost decade reflected distorted credit allocation and credit subsidies to weak firms, which reduced reallocation efficiency and depressed aggregate TFP growth.

This paper: A new mechanism: **"fiscal curse of easy borrowing"**

$$\text{low rates} \rightarrow \text{fiscal misallocation} \rightarrow \textit{TFP} \downarrow$$

Empirical Facts

- Government investment rises sharply in the 1990s
- Widening gap:

$$R^K - R^G \uparrow$$

- Strong **negative correlation**:

$$\frac{I_{it}^G}{G_{it}} \sim R_{it+1}^G$$

- Interest rate decline $\rightarrow$ borrowing surge

Interpretation:

- Not just "too much spending"
- But **wrong allocation of spending**

Model: Key Ingredients

Two-period setup

- Regions i, production:

$$Y_i = A_i G_i^{\alpha}$$

- Planner:

$$R_i^G = 1 + r \Rightarrow \text{efficient allocation}$$

- Political government:

$$U^G = U^H + \sum_i \kappa_i v(G_i)$$

- Debt Limit:

$$D \leq \overline{D} = \frac{bW}{1+r}$$

Key Mechanism: Capital Wedge

FOC:

$$(1 + \text{Political Distortion} - \text{Borrowing Shadow Cost})\, R_i^G = 1 + r$$

Two margins:

- **Overinvestment**
  - Easy borrowing $\rightarrow$ too much G
- **Spatial misallocation**
  - Allocation driven by κ_i, not A_i

Fiscal Curse of Easy Borrowing

Debt limit:

$$\bar{D} = \frac{bW}{1+r}$$

Lower r implies:

- Higher borrowing capacity
- Lower shadow cost of public funds

Result:

- Political motives dominate efficiency
- Allocation shifts from:
  - Productivity-driven $\rightarrow$ lobbying-driven

Implication:

$$r \downarrow \Rightarrow \text{TFP} \downarrow$$

Main Comment 1: Endogeneity of Low Rates

Paper's mechanism:

$$r \downarrow \Rightarrow \text{easy borrowing} \Rightarrow \text{misallocation} \Rightarrow TFP \downarrow$$

Alternative interpretation:

$$r \approx \theta g + \rho \tag{1}$$

$$\text{asset collapse} \Rightarrow \text{zombie lending} \Rightarrow \text{TFP growth } (g) \downarrow \Rightarrow \ r \downarrow$$

Potential reinterpretation:

- This paper may identify an **amplification mechanism**.

Zombie Ratio and its Effects on TFP during the Lost Decade

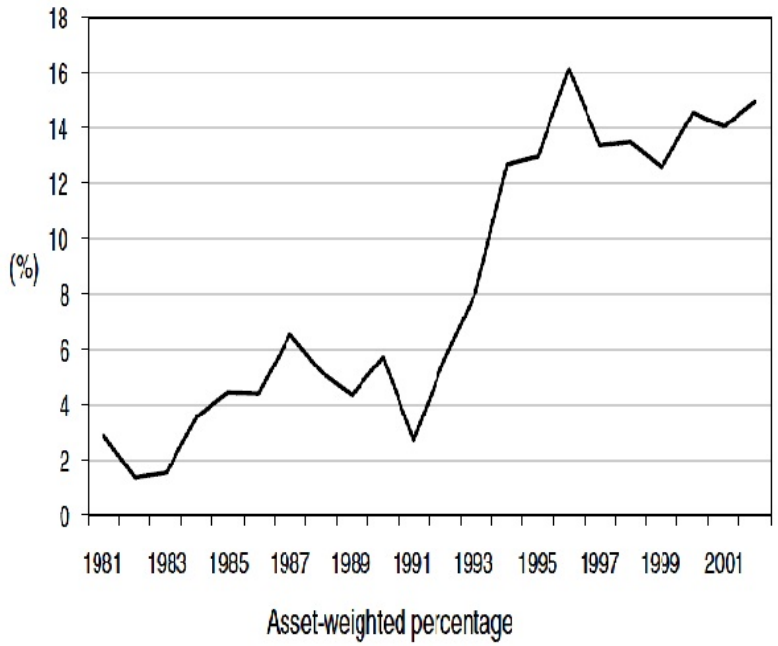

FIGURE 1. PREVALENCE OF FIRMS RECEIVING SUBSIDIZED LOANS IN JAPAN

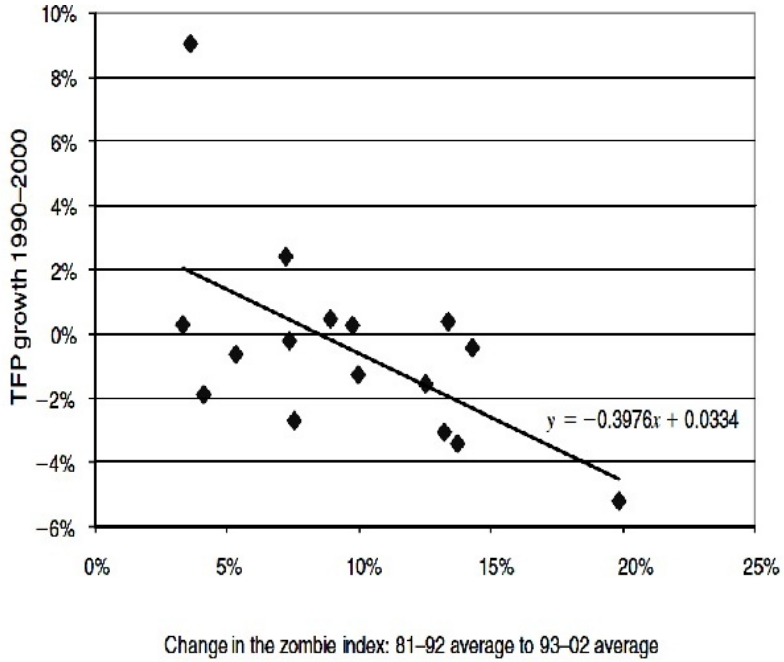

FIGURE 6. ZOMBIES AND TFP GROWTH

Figure: Zombie and TFP Growth (Source: Caballero-Hoshi-Kashyap (2008))

How Could the Paper Address This?

1. Embed fiscal channel into banking-distress framework

$$\text{banking distress} \rightarrow r \downarrow \rightarrow \text{fiscal amplification}$$

2. Emprical Strategy: Cross-prefecture heterogeneity

Test whether fiscal misallocation is stronger in:

- weak-bank regions
- larger land-price collapses
- higher zombie exposure

Exploit cross-prefecture heterogeneity: empirical strategy

$$\begin{aligned}\frac{I_{it}^G}{G_{it}} &= \alpha_i + \delta_t + \gamma \times R_{i,t+1}^G + \theta \left(R_{i,t+1}^G \times LostDecade_t \right) \\ &\quad + \beta \left(R_{i,t+1}^G \times Exposure_i \times LostDecade_t \right) + X_{it}\Gamma + \varepsilon_{it}\end{aligned}$$

- In an efficient allocation, high-return prefectures should receive more investment until the returns are equalized ($\gamma \geq 0$).
- This paper finds that in lost decade the opposite ($\theta < 0$)
- Question: whether this negative allocation-return relationship is stronger in prefectures more exposed to banking/zombie distress or larger land price falls ($\beta < 0$)

Exposure measures

- for weak-bank exposure

$$Exposure_i^{Bank} = \sum_b share_{ib,pre} \times Weakness_{b,pre}$$

  - $share_{ib,pre}$ is the pre-1990 dependence of prefecture i on bank b;
  - $Weakness_{b,pre}$ could be bank capital shortfall, NPL exposure, stock-price exposure, real-estate loan share, or later measured distress

- for land price collapose exposure

$$Exposure_i^{land} = -\Delta \log landprice_i$$

- for Zombie-firm exposure

$$Exposure_i^{zombie} = \sum_s EmploymentShare_{is,pre} \times ZombieShare_{is,pre}$$

Main Comment 2: Estimation of Fiscal Rule

- The paper esptimate the following fiscal rule

$$\frac{(a + r_{t+1}) D_{t+1}}{Y_t} = b$$

  using the aggregate time series data on government debt to GDP ratio and the interest rate.
- However, r_{t+1} might be endogenous to Y_t, creating a potential endogeniety issue.
- better to use IV or internal parameter estimation for correcting this endogeneity issue.

Main Comment 3: MPK Dispersion and Interpretation

Core empirical fact:

$$R^K - R^G \uparrow \quad \text{during Lost Decade}$$

Paper's interpretation:

- Misallocation of government capital

Alternative (macro-finance) interpretation:

- Equilibrium asset pricing:

$$R_t^H = \alpha_H \frac{Y_t}{q_{t-1}^H G_t} + \frac{q_t^H}{q_{t-1}^H}(1-\delta) - 1 \text{ for } H \in \{G, K\}$$

- Government capital priced differently, due to difference in risk, liquidity, policy backing

Key question:

- Does R^G in data capture marginal product, or an **equilibrium return**?

Main Comment 4: General Equilibrium Effects?

Paper's focus:

- Misallocation within government investment

But in equilibrium

- Government investment competes for savings $\Rightarrow$ affects asset prices and returns

Key mechanism likely missing:

- $G \uparrow \Rightarrow r^K \uparrow \Rightarrow K \downarrow$
- Crowding out of high-MPK private capital
- Welfare cost (0.31%) is likely **substantially underestimated**

Specific Comments

- **Welfare decomposition**: Separate welfare gains from improved spatial allocation versus reduced over-investment across various policy experiments
- Source of large welfare gain of the benevolent planner: TFP (welfare) increase by 9.22% (11.93%)
  - mutiple policy instruments (κ_{it} and lump-sum transfer to young ($\{T_{t+j}\}_{j\geq 0}$)
  - or largely from no political distortion ($\kappa_{it} = 0$)?
- Why does misallocation reverse after 2002?

Summary

- Very interesting and important insights

$$\text{Interest rates} \rightarrow \text{Fiscal behavior} \rightarrow \text{Misallocation}$$

- Main takeaway:
  - Fiscal expansion is not neutral
  - Its **allocation** matters critically

- My interpretation: the paper identifies **a fiscal amplification mechanism** within Japan's broader stagnation dynamics.
- Suggestions: address the potential endogeniety of r .