# Policy Discretion under Persistent Private Information*

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**Abstract**

This paper analyzes the optimal level of discretion in policymaking. Our application is a dynamic fiscal policy model in which the government has a present-bias towards public spending. Society trades off its desire to allow the government to react to its private information about the state of the economy against its desire to prevent the government from engaging in excessive spending. In contrast to previous research, we allow the government's private information to be persistent. We consider the optimal fiscal rules implied by this mechanism design problem. We present three main results which emerge only when private information is persistent. First, the optimal mechanism admits rules which are ex-post suboptimal for social welfare. Second, the optimal rules depend not only on payoff-relevant states, but on the entire history of realized states. Finally, the optimal rule is not a government spending limit. Motivated by these results, we develop a definition of renegotiation-proof mechanisms and show that the optimal renegotiation-proof mechanism is a state-dependent spending limit.

**Keywords:** Macroeconomic Policy, Institutions, Asymmetric and Private Information, Structure of Government

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