Letter

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Fiscal Rules: Anchors of Stability

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Abstract: We believe that fiscal rules help to consolidate budgets in the post-Corona period. Fiscal rules reduce fiscal deficits and debt-to-GDP ratios, promote economic growth, mitigate room for fiscal manipulation and encourage politicians to prioritize individual policies.

Keywords: fiscal rules, fiscal consolidation, post-Corona period

The Corona-crisis gave rise to a recession. In OECD countries, GDP growth declined by 4.1% in the year 2020. Governments issued new debt to handle the Corona-crisis and to use fiscal policy as a countercyclical tool. Consequently, public debt-to-GDP ratios in OECD countries increased rapidly from 71.7% in the year 2019 to 88.1% in the year 2020. Issuing new debt was supported by interest rates still been kept historically low. But in any event, rising debt-to-GDP ratios threaten the sustainability of public finances in many industrialized countries. Governments will need to consolidate budgets soon. A major question is how budget consolidation should be done. Governments may increase taxes and/or decrease public expenditure. In that respect, cutting back public expenditure has been shown to be the more suitable avenue (e.g., Alesina, Favero, and Giavazzi 2019). Whatever governments do, in the medium term they need to make sure, at least, that deficits grow to a smaller extent than GDP. The increase of public indebtedness must be limited to ensure fiscal sustainability.

We believe that fiscal rules help to consolidate budgets in the post-Corona period. Fiscal rules reduce fiscal deficits and debt-to-GDP ratios, promote economic growth, mitigate room for fiscal manipulation and encourage politicians to prioritize individual policies.

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1 Case Studies

Public debt had increased drastically after the public debt crisis that began in the fall 2007. In countries such as Germany, fiscal rules helped to reduce public debt (Feld and Reuter 2021; Fuest, Gründler, and Potrafke 2019). The German government introduced the debt brake in the German constitution in the year 2016. It became effective in the year 2016 at the national level and in the year 2020 in the German states. The public debt-to-GDP ratio decreased from 81% in the year 2010 to 60% in the year 2019. In Switzerland, the debt brake was introduced in the year 2003 and helped to decrease the public debt-to-GDP ratio from 26% in the year 2003 to 14% in the year 2019 (Salvi, Schaltegger, and Schmid 2020; Schaltegger and Salvi 2021).

2 Cross-country Evidence

Empirical studies have shown that fiscal rules decreased budget deficits and public debt-to-GDP ratios (Heinemann, Moessinger, and Yeter 2018). Based on a large sample of 132 countries over the period 1945–2015, Asatryan, Castelléon, and Stratmann (2018) show, for example, that the debt-to-GDP ratio decreased by on average 11% points when constitutional-level balanced budget rules were introduced.

Fiscal rules, especially those that restrict politicians' leeway for new debt, promoted economic growth (Gründler and Potrafke 2020a, 2020b). Empirical evidence based on data for a historical sample from the Industrial Revolution until World War II (1789–1950), a sample of modern growth (1985–2015), and a sample of 206 regional governments from 10 federal states (1992–2012) shows that real per capita GDP was higher in countries/states that anchored fiscal rules in their constitutions than in those countries/states that did not anchor fiscal rules in their constitutions. When handling endogeneity concerns and using a new instrumental variable in the modern sample, the cumulative long-run effect of anchoring strong fiscal rules on real per capita GDP is 18%. In a similar vein, countries that had fiscal rules overcame crisis in a better manner than countries that did not have fiscal rules (Kriwoluzky, Pagenhardt, and Rieth 2020).

3 Limiting Room for Political Manipulation

Politicians need to be re-elected to shape policy decisions. The political business cycle theories describe that politicians implement expansionary fiscal policies before elections to increase reelections prospects. Expansionary policies include increasing public expenditure, decreasing taxes and increasing public debt. Clearly, expansionary fiscal policies are needed to stabilize the economy in recessions. The Corona-crisis has been a recent example for when expansionary policies are useful. Expansionary fiscal policies are not useful, however, to manipulate the economy when election-motivated politicians seek to stay in office. A new study by Gootjes, de Haan, and Jong-a-Pin (2020) shows that fiscal rules may well help to mitigate political business cycles.

Another sort of manipulation comes from budget forecasts to be strategically used for relaxing the budget constraint. Lüchinger and Schaltegger (2013) show that fiscal rules can commit politicians to less strategic optimism and pessimism and therefore more precise revenue and spending forecasts.

4 Political Priorities

Fiscal rules encourage politicians to prioritize individual policies. Transfers assume a large and rising share of governments' budgets. Social expenditure has become the largest budget item in many industrialized countries (Busch and Kauder 2021; Dorn et al. 2018; Potrafke 2020). There is a risk of "social dominance": social expenditure is crowding out expenditure for other core tasks such as providing infrastructure and safety and order (Schuknecht 2020; Schuknecht and Zemanek 2020). When politicians seek for re-election, increasing social expenditure is more likely to attract voters than increasing investment expenditure. Size of government is limited, however. Politicians and citizens need to (re)turn discussing which public expenditure should be prioritized.

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