(Un-)intended effects of fiscal rules☆

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ABSTRACT
The paper investigates the fiscal effects of Swiss cantonal debt brakes by taking explicitly into account the rules' coverage. An in-depth analysis provides unique evidence that suggests the following: First, fiscal rules reduce public deficits. The effect is stronger the better the analyzed budget position corresponds with the variable targeted by the rules. Second, cantonal debt brakes exhibit some unintended effects, i.e., an evasion into unconstrained accounts, emphasizing the importance of constraining all accounts. Third, the existence of political budget cycles depends on the institutional context, i.e., the timing of elections and the presence of debt brakes. Fifth, cantonal debt brakes dampen the fiscal deterioration during unexpected deficit shocks by more rapid fiscal adjustments.

1. Introduction

It is widely acknowledged that democratically elected governments have a tendency to run budget deficits and incur debt. A prominent solution to constrain fiscal policy and alleviate excessive deficits is the introduction of fiscal rules. Such constraints have a long tradition in Switzerland. Over 88 years ago, on 17th June 1929, the canton of St. Gall implemented what is today often referred to as the first debt brake. While fiscal constraints were not new in 1929, St. Gall’s regulation has been particularly strong and credible as ever since it entails innovative elements such as a correction mechanism.1

However, the intended effect of fiscal rules, i.e., disciplining policy-makers, might be undermined as politicians often find ingenious ways of retaining fiscal discretion while formally satisfying fiscal rules at the same time. In the end, fiscal rules might constrain the targeted variable perfectly, while no substantial improvement of the overall fiscal position prevails. It thus seems essential to differentiate between the direct effect of fiscal rules on the targeted variable and the consequential (unintended) indirect effects, e.g., evasive reactions, which could counter the initial effect.

In addition, the impact of fiscal rules might vary with the circumstances in the restricted entity. In times of political stability and buoyant revenue, fiscal constraints should only play a minor role. If a jurisdiction is, however, hit by a fiscal shock, then the fiscal rules might take their full effect and mitigate a shock-related deterioration of public finances. Similarly, the impact of fiscal rules should be particularly notable before elections as incumbents are generally tempted to conduct an expansionary fiscal policy in order to win the upcoming election.

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1 By comparison, lax fiscal rules can be found already in the 19th century in, e.g., the Kingdom of Bavaria, the German Empire and in some US states and other Swiss cantons.

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The paper addresses these issues by exploiting a rich dataset that covers the 26 Swiss cantons (states) during the years 1980–2011. As most cantons have introduced a debt brake by now, Switzerland provides a natural laboratory to empirically test the impact of fiscal rules. The paper stands out from previous studies as we are among the first to investigate the effect of fiscal rules on various budget components, evasive measures, political budget cycles and on the responsiveness of cantonal budgets to fiscal shocks. A difference-in-differences approach shows that the deficit-constraining impact of fiscal rules at the cantonal level is stronger the more narrowly defined the analyzed budget variable is – i.e., the better the analyzed budget position corresponds with the variable targeted by the rule. In line with the deficient coverage of most cantonal fiscal rules, we find some evidence that debt brakes are associated with increased spending in the (unconstrained) investment budget but not in the (constrained) current budget. The results emphasize the importance of implementing fiscal rules that legally cover all accounts. In addition, we provide unique evidence that cantonal debt brakes, which are particularly effective in times of crisis, mitigate shock-related deficits. Moreover, the effect of elections on cantonal finances depends on the institutional context (i.e., the timing of elections and the presence of debt brakes).

The remainder of the paper is organized as follows: Section 2 reviews the empirical literature; Section 3 briefly describes the cantonal political and fiscal framework; Section 4 presents anecdotal evidence, the empirical strategy and the model; Section 5 shows the baseline results; Section 6 discusses the robustness tests and Section 7 concludes.

2. Literature review

A large range of literature on fiscal rules has emerged subsequent to Proposition 13 that limits property taxation in California. Despite the myriad of studies, Alesina and Passalacqua (2016) recently called for “more econometric work to quantify the benefits of balanced budget rules.” We investigate the effects of fiscal rules on different budget components, political budget cycles and the responsiveness of cantonal budgets to fiscal shocks. Thereby the paper is broadly related to four areas of research:

A first strand of literature scrutinizes the effects of fiscal rules on public finances. Mitchell (1967) and Pogue (1970) were among the first to study the impact of fiscal constraints on US state finances. Most subsequent studies on the US suggest that strong budget rules support fiscal discipline – though the effect depends on the type and design of the rule. Similar evidence is provided for other countries.2 Interestingly, Reuter (2015) shows that, even though they are often violated, fiscal rules are effective as they act as a kind of benchmark for good fiscal policy in EU countries. Analyzing a similar panel, Bergman et al. (2016) conclude that fiscal rules and government efficiency are institutional substitutes in terms of promoting sound public finances. By focusing on US states Hou and Smith (2010) and Mahdavi and Westerlund (2011) reveal the importance of choosing the proper budget balance variable. Their findings show that the impact of fiscal rules is more pronounced the more narrowly defined the underlying budget variable is.

With respect to Switzerland, several studies provide evidence that cantonal budget rules, i.e., debt brakes, are associated with lower deficits, while their impact on expenditure and revenue is ambiguous. However, the existing studies on Switzerland do not differentiate between intended effects (on the targeted budget components) and unintended effects (on the non-restricted budget components) of fiscal rules. Moreover, most papers analyze insufficient datasets with few fiscal rules, ignore the rules’ (deficient) coverage or neglect fixed effects and issues of cross-sectional correlated standard errors (Table 1).

A second area of research analyses the relation between fiscal rules and evasive reactions. As fiscal gimmicks are hard to measure, empirical studies focus primarily on stock-flow adjustments in the EU or on unrestricted budget instruments in the US. Evidence for these countries largely suggests that politicians use various guises of fiscal gimmickry to evade fiscal rules.3 McCubbins (2010) shows that the success of California’s Proposition 13 in constraining taxes, was undercut by unintended secondary measures like the devolution of fiscal responsibilities to agents who are not subject to the limitations or the creation of new tax and spending authorities. The Swiss case has hardly been studied so far in this respect. This is surprising as Luechinger and Schaltegger (2013) explicitly mention that their finding of fiscal rules improving deficits could, at least partly, be due to creative accounting operations.

Similar to creative accounting, a vertical shifting of financing responsibilities to other levels of government can be seen as hidden device to circumvent fiscal rules and regain fiscal discretion. The few existing studies on such evasive behavior provide mixed evidence for the US (e.g., Nice, 1991; Von Hagen, 1992; Kiewiet and Szakaly, 1996). Regarding the Swiss case, Burrett and Feld (2017), by analyzing local reactions to cantonal fiscal rules with local data, find that Swiss cantonal budget constraints do not burden local finances. If anything, the cantonal rules support sound finances at the local level of government. Similar evidence is provided by Feld and Kirchgaessner (2008) using combined data of the cantonal and local levels.

A third line of research focuses on the interaction between fiscal rules and political budget cycles. Literature frequently suggests

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2 For the US, the literature has recently been surveyed by Burrett and Feld (2014). For Canada refer to Imbeau and Tellier (2004) and Tapp (2013), for Latin America to Alesina et al. (1999), for African countries to Goldsworthy (2010), for OECD countries to Guichard et al. (2007), for EU countries to de Haan et al. (1999), Ayuso-i-Casals et al. (2007), Hallerberg et al. (2007), Debrun et al. (2008), Grembi et al. (2013), Marneffe et al. (2011) and Foremny (2014) and for various economies to Singh and Plekhanov (2006), Lavigne (2011) and Blume and Voigt (2013). A recent meta-analysis confirms a constraining impact of fiscal rules (Heinemann et al., 2017). Related studies examine the effects of fiscal constraints on official budget forecasts (e.g., Frankel, 2011; Beetsma et al., 2009; Pina and Venes, 2011; Holm-Hadulla et al., 2012; Frankel and Schreger, 2013). Similar to fiscal rules, a vast array of studies show that direct democratic institutions support fiscal discipline. For evidence on the US refer to, e.g., Matuszaka (1995) and on Switzerland refer to, e.g., Feld and Kirchgassner (2001a, 2001b), Feld and Matuszaka (2000), Feld et al. (2008), Funk and Gathmann (2011) and Galletta and Jametti (2015).

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