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Balanced budget rules and fiscal outcomes: Evidence from historical constitutions[☆]

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ABSTRACT

This paper studies the reduced-form effects of constitutional-level balanced budget rules (BBRs) on fiscal outcomes. Using historical data for a large set of countries dating back to the nineteenth century and applying a difference-in-difference design we find that the introduction of a constitutional BBR leads to a reduced probability of experiencing a sovereign debt crisis. We estimate that debt-to-GDP ratio decreases by around eleven percentage points on average, most of these consolidation being explained by decreasing expenditures rather than increasing tax revenues. Using the same methodology and sample, we do not find evidence that non-constitutional BBRs included in national legislation affect these variables. Additional estimates gained from applying the synthetic control method on nine selected case study countries in Africa, Europe, and Latin America are consistent with the main findings, but also highlight the importance of country specific circumstances when evaluating the success of BBRs.

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1. Introduction

Average government debt-to-GDP and spending-to-GDP ratios around the world roughly doubled in the fifty years after WWII. Compared to the few data points that we have from the late nineteenth century, the spending-to-GDP ratio has roughly quadrupled. In a long and heated debate, both academics and policy makers have questioned the reasons for the problem of running persistent deficits and thereby accumulating debt. The global economic and financial crisis of 2008–9 quickly evolved into a sovereign-debt crisis in many countries, once again bringing the issue of sustainable public finances to the forefront of policy priorities and motivating policy makers to find effective and credible institutional solutions. In particular, fiscal rules have become a popular instrument to constrain fiscal policy and are currently promoted by national governments and international organizations such as the IMF and the EU.

However, the use of fiscal rules is not a new idea, as illustrated by US states and the Maastricht Treaty in Europe, and the global financial crisis gave prominence to the fact that governments often fail to comply with these rules.[1] As a response to the crisis and motivated by the Fiscal Compact Treaty in Europe, a recent trend has been to strengthen the credibility of these fiscal rules by enshrining them at the highest level of law: national constitutions.[2] Austria, Denmark,

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1 For example, in the European Union, more than half of member states exceeded the three percent maximum budget deficit specified in the Stability and Growth Pact.

2 The Fiscal Compact – or formally the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union – requires the member states to enshrine structurally balanced budget rules into domestic law.

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Italy, and Spain are some of the countries that have passed such legislation in the post-crisis era,[3] joining Switzerland[4] and Germany[5] which are the two exceptions among advanced countries that already had such constitutional rules.[6] Other countries have hotly debated but not implemented constitutional fiscal rules. For instance, in the United States, the House of Representatives approved a balanced budget amendment in 1995 that fell short by one vote in the Senate. A similar attempt failed in 2011 (Azzimonti, 2013).[7]

On the other hand, about forty-five countries in the world – particularly in Africa, Central America, and South America – have had balanced budget rules (BBR) in their constitutions.[8] Some of these provisions date back to the end of the nineteenth century but most were introduced in the first and second halves of the twentieth century in the Americas and Africa, respectively, and in Europe following the crisis of 2008–9. In this paper, we present the first historical evidence on the fiscal effects of these constitutional fiscal rules. Studying the effect of BBRs in these countries is appealing because provisions written in a country's constitution might be more binding than non-constitutional laws.[9] This expectation has been an explicit assumption made by many policy makers, such as when designing the Fiscal Compact Treaty, but for which no empirical evidence exists.

This paper contributes to the existing literature on the effects of fiscal rules by: (a) studying the fiscal effect of BBRs that are enshrined in national constitutions; (b) analyzing historical data dating back to WWII (as our preferred sample) but also to the nineteenth century (as our largest sample); and (c) studying the effects of BBRs on government debt, expenditures and taxes, but also on the incidence of sovereign debt crises.

Identifying the effect of (non-randomly distributed) fiscal rules on fiscal outcomes is challenging for several reasons. First, there exists the possibility of selection bias such that past fiscal outcomes might influence the probability that a government implements a fiscal rule. Second, biased estimates may arise from the failure to account for shocks which simultaneously drive the implementation of fiscal rules and correlate with fiscal outcomes. Third, the adoption of constitutional BBRs by definition involves a change in the constitution either through amendments or the adoption of a new constitution. Thus, the independent effects on fiscal outcomes due to any additional changes in constitutions, that occurred at the same time as the introduction of BBRs, must be ruled out.

We start our analysis with quantitative case studies for nine countries in Africa (Cape Verde, Gabon, and Rwanda), Europe (Switzerland and Ukraine), and Latin America (Brazil, Chile, Panama, and Peru) employing the synthetic control method (Abadie and Gardeazabal, 2003; Abadie et al., 2010).[10] For each of these countries, we estimate the counterfactual levels of fiscal policy variables after introducing or abolishing a BBR; that is, the fiscal outcomes in a hypothetical country with or without a BBR. These counterfactual outcomes are then compared to the actual fiscal variables. In the majority of cases, the synthetic control approach provides first evidence that BBRs constrain the levels of government debt and expenditures.[11]

Studying countries individually helps to better understand the complex endogeneity issues associated with the adoption of these rules. The Swiss case described in Section 3 is illustrative in that the debt brake introduced in 2003 led to a significant episode of fiscal consolidation which, according to our estimates from the synthetic control method, amounts to a large reduction of the debt-to-GDP ratio by about 30 percentage points. However, as suggested by the case study of Fig. 1, the adoption of the debt brake followed or perhaps was a reaction to a period of steady increase of government debt in Switzerland. This case would speak in favor of some bias coming from the selection of already indebted Switzerland into adopting a BBR.

For our baseline estimations, we adopt a generalized difference-in-difference design. In its dynamic specification, we model the timing of the introduction of a BBR, and show that in the years leading to the adoption of BBRs the differences in outcome variables between treatment and control countries is, on average, close to zero. This absence of pre-trends suggests no systematic bias coming from selection as long as the selection effect is: i) captured by the observables, and ii) homogenous across countries so that the average effect on the pre-trends does not mask potentially offsetting trends. The use of a set of country and continent-specific year fixed effects enables us to control for unobservable factors that do not vary within countries or within continents in given years. We also control for country-specific parametric time-trends and capture the effect of several time-varying observable variables such as the quality of democratic institutions, but are not able to fully account for unobservable factors with unknown parametric functions. The case studies also suggest that the majority of BBRs were implemented by introducing a new constitution, which may be a confounding event. However, when using constitutional changes as the treatment variable in the difference-in-difference specification we do not find evidence that these changes generally matter for our outcome variables.

Using our preferred sample of 132 countries from 1945 to 2015[12] we show that; *first*, the introduction of a BBR is associated with a reduction in the likelihood of experiencing a sovereign debt crises as defined by Reinhart and Rogoff (2011). This finding shows that not

[3] Others include: Georgia, Hungary, Latvia, Malta, Serbia, Slovakia, and Slovenia, with further ongoing processes in all of the European countries that have signed the Fiscal Compact.

[4] Switzerland introduced a BBR constraining structurally adjusted balances that has been in effect since 2003. For a quantitative case study on Switzerland, see Section 3.

[5] Germany first introduced a fiscal rule into its constitution in 1871 (reinstating it in 1949). In 2009, a major amendment came ("Schuldenbremse": Article 109.3) that caps the level of the federal government's structural deficits at 0.35% of GDP effective in 2016 (and the states' level at zero, binding from 2020). The pre-2009 "golden rule" limited net borrowing to the level of gross public investment, which, along with further and very general escape clauses, made the rule less effective (see Feld, 2010; Ciaglia and Heinemann, 2012; Heinemann et al., 2016). Germany's reform kicked off a debate on whether the eurozone countries should insert a German-style BBR into their constitutions (Janeba, 2012).

[6] Portugal had a rule in the 1820s, but it was short-lived. Also, Poland (Article 216.5) and Singapore (Article 114) have had certain constitutional limitations on borrowing since 1997 and 1965, respectively, but it is controversial whether these should be considered as BBRs (Lienert, 2010).

[7] See Schultze (1995) and Seto (1997) for a discussion of the 1995 proposal, and Azzimonti et al. (2016) for a welfare analysis of a 2011-type BBR with a model calibrated to the US economy. The debate on introducing a balanced budget amendment continues today with around half of state legislatures having passed resolutions calling for such an amendment.

[8] See Fig. 4 for a map and Table B1 in the online appendix for the list of these countries.

[9] For example, in the United States, expenditure and balanced budget rules in the '80s and '90s were phased out or abandoned as corresponding laws were rewritten. Further, supranational deficit caps in the European Union as defined by the Maastricht Treaty of 1992 and the original Stability and Growth Pact of 1997 were also often exceeded which eventually led to significant reforms of the Pact (for example, Six Pack, Two Pack, Fiscal Compact, and further ongoing reforms).

[10] Köhler and König (2015), Pfeil and Feld (2016), and Eliason and Lutz (forthcoming) use the synthetic control method to study the effects of fiscal rules in, respectively, euro-area countries, Switzerland, and one US state. Asatryan (2015) presents case study evidence on the effects of constitutional changes, and Metelska-Szaniawska (2016) applies the method to the analysis of constitutional changes in post Soviet countries.

[11] We perform case studies in nine out of thirty-six countries in our baseline sample due to the higher data requirements of the synthetic control method. Please refer to Section 3 of the Online Appendix for a detailed discussion.

[12] In other specification, our largest sample goes back to 1800 and covers at most 224 countries. While our estimates are robust across these specifications, BBRs vary little in the early years of our sample and, therefore, we focus on the more recent data as our preferred sample.

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