Journal of Economic Behavior & Organization 144 (2017) 133–152

Contents lists available at ScienceDirect

Journal of Economic Behavior & Organization

journal homepage: www.elsevier.com/locate/jebo

Mechanisms for the control of fiscal deficits☆

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ARTICLE INFO

Article history:
Received 4 May 2017
Received in revised form
18 September 2017
Accepted 20 September 2017
Available online 23 September 2017

JEL classification:
D82
H62

Keywords:
Fiscal policy rules
Constitutional choice
Mechanism design

ABSTRACT

This paper shows that a simple two-stage voting mechanism may implement a constrained optimal state dependent decision about the size of the fiscal deficit. I consider a setup with strategic fiscal deficits similar to Alesina and Tabellini (1990). Three groups of voters are informed about the relative desirability of current public spending. Voters differ in their preferences for public goods and swing voters' preferences may change over time. The current government decides on the current spending mix and it has an incentive to strategically overspend. A simple two-stage mechanism under which a deficit requires the approval by a supermajority in parliament approximates a constrained optimal decision and under certain conditions increases social welfare relative to both a strict rule and a laissez faire constitution. When the current majority is small, political bargaining may further increase social welfare. However, when the current majority is large, a supermajority mechanism with bargaining leads to a biased spending mix and it may reduce welfare whereas the laissez faire mechanism may yield the first best. An appropriately adjusted majority threshold can avoid inefficient bargaining whenever necessary.

1. Introduction

Designers of fiscal policy institutions have to deal with a fundamental trade-off. On the one hand, elected policymakers face limited or uncertain periods in office which can create a bias towards excessive spending. This bias needs to be corrected through an appropriate regulation of fiscal policy. On the other hand, fiscal flexibility is desirable because new information about economic circumstances and political preferences may require a flexible fiscal policy reaction. Any suitable institutional arrangement has to address both problems at the same time. This paper formally studies institutional arrangements that reduce strategic fiscal deficits while still permitting some fiscal flexibility.

There are many different reasons to increase government spending at a specific point of time. This includes periods of Keynesian unemployment, natural disasters, war, the occurrence of a particularly profitable public investment opportunity or situations in which the fiscal multiplier is particularly large (as some economists have argued at the beginning of the

☆ I thank two anonymous referees for several very useful comments, seminar participants at the European Central Bank, the University of Mannheim, ZEW and the Banco de Espana and BGSE conference "Fiscal Sustainability XXI Century" and Felix Bierbrauer, Pierre Boyer, Micael Castanheira, Antonio Ciccone, Tobias Etzel, Antoine Loeper and Philipp Zahn for helpful comments and discussions and Astrid Reich for editorial assistance in preparing the figures. The first version of this paper has been prepared by the author under the Wim Duisenberg Research Fellowship Programme sponsored by the ECB. Any views expressed are only those of the author and do not necessarily represent the views of the ECB or the Eurosystem.

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http://dx.doi.org/10.1016/j.jebo.2017.09.019
0167-2681/

financial crisis in 2008). In such situations there may be a consensus that the government should spend more money, while voters and elected politicians may still disagree about the direction of spending.[1]

It is well established in the literature (Alesina and Tabellini, 1990; Tabellini and Alesina, 1990) that the disagreement about the direction of public spending may lead to strategic overspending. Tying policymakers' choices through strict constitutional deficit ceilings is a direct way of addressing this problem. In order to maintain some fiscal flexibility, constitutions often contain exemption clauses that permit exceptions under circumstances that make a fiscal policy response particularly desirable.[2] However, formulating exception clauses can be very difficult when relevant information about the need for discretionary fiscal policy responses is not contractible ex ante or not verifiable ex post.[3] It would be prohibitively costly to fully specify at the constitutional stage, what kind of situation makes an elevated fiscal deficit (or a surplus) acceptable in the (partly distant) future and to specify the appropriate size of the deficit. Even if some relevant events can be specified in a constitution, it may be difficult to verify their realization ex-post. Any constitution that addresses the problems of fiscal sustainability and fiscal flexibility has to specify how the political system shall deal with non contractible and non verifiable information.

This paper addresses this constitutional choice problem from a mechanism design perspective. In my model, fiscal policy decisions should ideally depend on the realization of two random variables: The desired spending mix of the majority of citizens and the relative desirability of public spending at different points of time. Voters differ in their preferences for two public goods. Moreover, all voters and all policymakers are equally well informed about the relative desirability of current vs. future public spending. This is why, for any given spending mix, all voters would agree on the optimal time path for public spending. However, I assume that neither the spending mix nor the desirability of current public spending are contractible at the constitutional stage. In this environment, it is the role of political institutions to base decisions regarding the spending mix and the deficit on voters' preferences and on the realization of the preference for current spending. By assumption, the constitution can only specify how decision rights are allocated to political parties. The political party that represents the majority of citizens should choose the (current majority's desired) spending mix. However, as in Alesina and Tabellini (1990) and Tabellini and Alesina (1990) this government has an incentive to strategically overspend. In such a situation, a welfare maximizing choice of the spending level requires that the government spends less than it would like to. I derive conditions under which a simple revelation mechanism can either approximate or fully implement such a welfare maximizing outcome.

A mechanism designer who wants to implement a spending level for the current legislative period is operating under the constraint that, at any point of time, the spending mix is the one that the current political majority prefers. For a given realization of the preference for present spending, I call a spending level constrained optimal if it maximizes social welfare under this constraint. I first analyze a simple revelation mechanism that asks both political parties for simultaneous announcements regarding the realized preference parameter. The mechanism then implements the corresponding deficit. If the two announcements differ, a low default spending level is implemented. When the relative desirability of current government spending is sufficiently large or sufficiently small, this mechanism implements the constrained optimal collective choice. Moreover, for any given strict budget rule one can find a default maximum spending level such that the corresponding revelation mechanism yields a higher social welfare than a strict rule.

Any revelation mechanism requires a structured procedure with simultaneous announcements that are then transformed into outcomes. Such a procedure may be difficult to implement in practice. In a second step, I show that a similar state dependent outcome can be implemented by a simple three-step supermajority mechanism. In the first step, the government asks the parliament to accept a specific deficit level that may exceed a prespecified value. The approval of the deficit requires a supermajority in parliament whenever the deficit exceeds the prespecified value. In the second step, the parliament may accept or reject the proposal. If the proposal is rejected then the size of the budged may not exceed the prespecified size. In the third step the government decides on the spending mix, taking into account the parliament's decision. I show that, for any given budget rule one can find a supermajority mechanism that yields a higher social welfare.

In a two-party system, a supermajority mechanism grants the opposition party a veto right on any budget that exceeds a prespecified absolute or relative deficit level. In this sense it closely resembles the practice in the U.S. where the government can only increase government debt beyond a prespecified value if the House and the Senate both give their approval. Over the last 30 years the composition of the two chambers and the president's party affiliation only fit together in 8 years. This effectively turned the U.S. mechanism into a rule that most of the time gives both parties a veto right on any budget that is not in line with the debt ceiling – similar the supermajority mechanism that is studied in the present paper. The present

[1] Note that these are intrinsic events in the sense of Goenka (1994) who argues that fiscal flexibility also permits the government to deal with sunspots (extrinsic uncertainty).

[2] For an early empirical analysis of fiscal rules see von Hagen (1991) and for a discussion of the role of strict fiscal rules and exemption clauses in constitutions see Wyplosz (2005).

[3] According to article 3 of the European fiscal compact "the Contracting Parties may temporarily deviate from their respective medium-term objective or the adjustment path towards it only in exceptional circumstances". In line with this, exemption clauses were recently included in new institutional arrangements in France, Germany, Italy, and Spain. However, similar constitutional rules have produced rather disappointing outcomes in the past. E.g. between 1969 and 2009, Article 115 of the German constitution ruled out that the federal government's annual fiscal deficit exceeds the annual amount of public investment. However, under exceptional economic circumstances the rule was not supposed to be binding and the government could unilaterally decide that an exception is acceptable. Moreover, the concept of investment in Article 115 has been quite vague. In 1989 the German constitutional court argued that the rule is useless because government debt continued to increase significantly while the rule was in place.