A QUEST FOR FISCAL RULES

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The Quest for Fiscal Rules

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The Quest for Fiscal Rules

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Abstract
James Buchanan pioneered the political economics of public debt 60 years ago. In this paper, we contrast his thinking of the burden of debt, the public choice mechanisms that lead to excessive debt and the demand for constitutional restraints on public debt with its development, its sustainability, the evidence on the political economy of debt and on the effects of institutions. It turns out that Buchanan farsightedly anticipated the problems that would emerge from excessive indebtedness in the developed world. The introduction of fiscal rules appear as a late triumph of Buchanan’s thinking. However, socialism is dead, but Leviathan lives on. Opposition to sound fiscal policies has increasingly dominated the public debates since the Great Recession.

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Jim Buchanan was concerned with problems of public debt throughout his academic career. Starting with his first monograph *Public Principles of Public Debt* (Buchanan 1958) via *Democracy in Deficit* (1977), his book with Dick Wagner, to papers in the 1990s (e.g., Buchanan 1997), he analyzed the incidence of public debt, the Keynesian shift in fiscal policy, their meaning for political decision-making processes and the necessity for constitutional restraints on public debt. Indeed, his insights on public debt incidence, the question that, according to Brennan in his foreword to Volume 2 of *The Collected Works*, came to him as a flash of inspiration, only provided for a starting point of subsequent analyses. If public debt constitutes a burden to future taxpayers, it might induce decision-makers in current politics to incur excessive indebtedness and reveal a deficit bias in fiscal policies. Such deficit bias should be restrained by constitutional rules in order to avert harm from future generations. Buchanan’s theory of public debt thus provided the foundation for an extensive and still growing public choice literature on the political economics of public debt.

His thinking on public debt is embedded in his theory of fiscal exchange (Buchanan 1949, 1967). Buchanan’s basic concern was that the democratically constituted Wicksellian link between public spending and revenue raising could be fundamentally harmed if today’s taxpayers vote for themselves expenditures on the expense of future generations. Access to public debt thus necessarily has an impact on the conduct of democratic politics. And Buchanan feared that this impact will not be a beneficial one.

In this paper, I will analyze to what extent Buchanan clearly and farsightedly anticipated the problems emerging from excessive indebtedness by starting in Section 2 with a brief look at the development of public debt across time and space. This is followed by remarks on different aspects of the sustainability of public debt in Section 3. In Section 4, I discuss the
reasons for public debt in the sense of a positive analysis, in particular focusing on the extensions of Buchanan’s thinking about excessive debt that finally lead to the quest for fiscal rules. In Section 5, the effects of such institutional restraints on public debt are summarized. Concluding remarks follow in Section 6.

2. Public Debt in Time and Space

Buchanan’s reasoning about public debt, at first glance, implies the existence of a deficit bias in fiscal policies leading to increasing debt across time. Figures 1 and 2 exhibit the development of debt to GDP ratios from the 1970s to 2017. In Figure 1 (left panel), the four member countries of the G7 which are not member states of the European Monetary Union (EMU) are displayed, while Figure 1 (right panel) shows debt to GDP ratios of the four large EMU countries, i.e., the remaining G7 countries plus Spain. I have taken the debt to GDP ratio because it plays a role in the discussion about debt sustainability. Real debt would even show a more dramatic time pattern.

Debt-to-GDP ratios of selected countries

Figure 1 shows that the development of debt to GDP ratios of the G7 countries and Spain since the 1970s differs considerably between these countries. The increase is most markedly in Japan which actually demands an own (the right-hand) scale in the left panel of Figure 1. At almost zero percent in 1970, Japanese public debt rose with little consolidation in the second half of the 1980s to about 250 percent of GDP in 2017. In the U.S., total government

Figure 1: Debt to GDP Ratios of Large OECD Countries, 1970 – 2017
Source: German Council of Economic Experts

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debt of all levels of government rose from about 1980 with consolidation in the second half of the 1990s to about 100 percent today. In Canada, this increase since 1980 was even stronger, consolidation in the 1990s until the Great Recession more thoroughly and the subsequent increase less considerable than in the U.S., such that the Canadian debt to GDP ratio is at about the same level as the U.K.’s. The U.K. has mainly suffered from the increase of the debt to GDP ratio induced during the Great Recession.

Regarding EMU member countries, an increasing trend is most obvious in France with almost no consolidation during these 47 years. Spain and Italy display increasing trends in their debt to GDP ratios until entering EMU, consolidating more or less, respectively, until the Great Recession, giving way for increasing debt again afterwards. While Italy with 132 percent has one of the highest levels of public debt to GDP in EMU, Spain and France have arrived at similar levels of almost 100 percent. Germany shares France’s increasing trend of public debt to GDP until the Great Recession, but deviates after 2009 with considerable consolidation of almost 20 percentage points.

**Debt-to-GDP ratios of selected countries**

![Debt-to-GDP ratios of selected countries](image)

Sources: IMF, Mauro et al. (2015), own calculations

**Figure 2: Debt to GDP Ratios of Small OECD Countries, 1970 – 2017**

Source: German Council of Economic Experts

Figure 2 shows the debt to GDP ratios of eight small member countries of EMU with the so-called program countries, those countries that underwent an adjustment program during the Eurozone crisis, displayed in the left panel of Figure 2, and four other members of EMU in the right panel. The strong increases in debt to GDP ratios in Greece, Portugal and Cyprus are
obvious, not only after the Great Recession, but also during the 1970s and 1980s. Ireland had a similar experience in the 1970s and 1980s, but started a period of strong consolidation in the second half of the 1980s that endured until the eve of the Great Recession. The tremendous increase of its public debt to GDP ratio during the Eurozone crisis has been followed by remarkable consolidation afterwards.

In Austria and Finland, debt to GDP ratios rose since 1970 with some fluctuations, but without clear-cut consolidation (see Figure 2, right panel). This is different in the Netherlands and Belgium which both experienced strong increases in government debt until the middle of the 1990s, considerable consolidation until 2007, a further surge in public debt after the Great Recession and some consolidation of its fiscal policies recently. The Netherlands managed to keep these fluctuations around the threshold of 60 percent debt to GDP ratio stipulated by the Maastricht Treaty and the Stability and Growth Pact. Belgium, however, started with a debt to GDP ratio of about 140 percent into EMU and reduced it to about 90 percent until 2007. Belgian debt meanwhile is at 100 percent of GDP.

This comparative exercise underlines several facts. First, there is an overall increasing trend in government indebtedness in percent of GDP in OECD countries. Almost all countries start from lower levels of debt to GDP in 1970 than they arrive at in 2017. Secondly, there are remarkable differences between those OECD countries. Debt to GDP ratios vary between 60 percent in Germany and the Netherlands and 250 percent in Japan. In Switzerland (not shown), it is even 35 percent only. Thus, the question emerges what is the reason for this variation and for the increasing trends. Alesina and Perotti (1995) arrived at the same observations and the same questions more than 20 years ago. Not much seems to have changed since, despite all fluctuations across time – except that the levels of the debt to GDP ratios are higher. These are only first impressions of a possible deficit bias in fiscal policies of OECD countries that must be further addressed in this paper. Before we consider this question, it is however necessary to look at the sustainability of public debt.

### 3. The Sustainability of Public Debt

Analyses on debt sustainability provide insights as to the extent to which public debt is shifted to future generations because they include many relevant aspects discussed in the old debate about burden shifting. If public debt is used for productive government spending, it can increase growth in the long-run, facilitating payments of interest and principal. The term productive spending avoids classifying it into public investment or public consumption as
both can be productive or unproductive depending on what the government actually spends money. Paying teacher salaries can economically be an investment in school children’s human capital as higher teacher salaries may attract better teachers, but it legally is public consumption. A bridge to nowhere is however unproductive although it is investment spending.

Of course, such a perspective does not fully acknowledge the different arguments brought forward in the burden shifting debate, in particular not Buchanan’s (1958, 1964) arguments. Yet, it indicates whether a country runs into the danger of exploding debt levels leading to sovereign default or sovereign debt restructuring. The most recent examples of Greece or Argentina illustrate what default implies for current generations if past governments of their countries followed irresponsible fiscal policies. The hardship current generations in these countries have had to undergo impressively illustrates what a burden of public debt means: Excessive public debt heavily reduces the fiscal space of those generations.

Economists have been concerned with the sustainability of public debt for a long time (see Domar 1944, Blanchard et al. 1990, Blanchard 1993). These analyses start from the intertemporal government budget constraint according to which a state, in contrast to private households or firms, will have to repay its debt only in the very long-run, i.e., in infinity. Public finances will be sustainable if

\[ d_0 = -\sum_{t=1}^{\infty} \left( \frac{1+y}{1+r} \right)^t p_t + \lim_{T \to \infty} \left( \frac{1+y}{1+r} \right)^T d_T \]  

(1)

with \( y \) as the growth rate of real GDP, \( d \) the debt to GDP ratio, \( r \) the real interest rate, \( p \) the primary balance and \( t \) the respective time period. This equation can be expressed in nominal terms allowing for an additional analysis of seigniorage.

Accordingly, government finances are sustainable if future primary surpluses in an infinite time horizon can cover government debt accumulated in the past. The ability to generate primary surpluses depends on real economic growth, i.e., the potential to raise revenue, and is counteracted by the real interest rates that must be paid to service debt. Already Domar (1944) shows that the necessity to generate primary surpluses depends on the relation between interest rates and economic growth. If the growth rate of GDP is higher than the interest rate, the debt to GDP ratio declines across time without primary surpluses. If the interest rate is higher than the growth rate of GDP, government must realize primary surpluses. Otherwise, the debt to GDP ratio will grow with continuous acceleration until the system collapses.
Figures 3 to 6 illustrate the movement of both time series, i.e., nominal interest rates and the growth rates of nominal GDP for Germany. Figure 3 covers the years between 1974 and 2010. During this time-period, Germany experienced notable economic shocks, namely the oil price and unification shocks, and entered a period of moderate economic growth. Aside yearly movements, the nominal interest rate was higher on average than the growth rate of real GDP. Given that during the same period an increasing trend in the debt to GDP ratio has obtained, it is natural that policymakers have become concerned with this development and introduced a debt brake into the German constitution (the Basic Law) in 2009.

The situation was quite different in the two decades before (see Figure 4). After the Second World War, in its economic miracle years, the German economy grew with much higher rates,
partly due to a rebuilding of the economy and other catch-up effects. Figure 4 shows that on average the growth rate of nominal GDP was higher than the nominal interest rate. The debt to GDP ratio remained flat despite the budget deficits that occurred from time to time. Public debt appeared to be financed by the growth of the economy.

It is difficult to judge whether the period between 1974 and 2010 or that between 1953 to 1973 is normal for Germany. It is essential for the sustainability of public finances that the interest rates in the intertemporal budget constraint, which are used to discounting the future values of the aggregates in equation (1), are high enough to obtain finite present values of these aggregates such that the infinite series of these flows converge absolutely (Homburg 1991). This is usually the case if the interest rate is higher than GDP growth, but not if the interest rate is lower. Theoretically, thus, much speaks in favor of the later period to reflect a rather normal situation. Figure 5 picks up the time before the First World War between 1871 and 1914 showing that during the gold standard, Germany had higher interest rates than GDP growth on average. This may serve as an additional illustration of the theoretical arguments.

![Figure 5: Nominal Interest Rates and Growth Rates of Nominal GDP in Germany, 1871 – 1914; Source: German Council of Economic Experts](image)

However, infinity is a sequence of finite steps. Economic shocks may hit the flows of fiscal aggregates frequently and thus require fiscal counter-action to help the economy recover from a shock. Figure 6 shows the German experience from 2008 to 2016. The German economy was hit by two shocks, first, the Great Recession in 2008 and, second, an interest rate shock as Germany has served as a safe haven during the Euro-crisis. On average, nominal interest rates are therefore somewhat lower than GDP growth since the financial crisis, allowing for a consolidation that relies on lower interest payments and higher public revenue.
GDP growth rate and long-term government bond yield for Germany

![Graph: GDP growth rate and long-term government bond yield for Germany, 2008–2016]

1 – Year-on-year change. 2 – Maturity over 9 to 10 years.
Source: Deutsche Bundesbank, Statistisches Bundesamt

Figure 6: Nominal Interest Rates and Growth Rates of nominal GDP in Germany, 2008–2016; Source: German Council of Economic Experts

Against this background, there are several test strategies in the empirical literature assessing fiscal sustainability ex post. One test strategy consists in stationarity tests on public debt and budget deficits. Public finances are sustainable if these series are stationary. In addition, cointegration tests of public debt and budget surpluses on the one hand or between public revenue and spending on the other hand are conducted. The estimation of Vector Error Correction Models (VECM) helps to identify long-run relations and short-term deviations. The question underlying these analyses is whether current public debt is equivalent to discounted future primary surpluses, i.e., the intertemporal budget constraint. The necessary condition for fiscal sustainability is thus tested. Burret, Feld and Köhler (2013, 2016, 2017) report such analyses for Germany and conclude that neither total government finances nor those of the Laender (states) are sustainable.

A second test strategy estimates linear fiscal reaction functions. If there is a positive reaction of primary balances on the level of public debt, then a sufficient condition of fiscal sustainability obtains (Bohn 1995, 1998, 2008). The basic idea of this test strategy is compatible with the argument that such reactions reflect the ability of governments to redeem their debt in the future. This ability also includes the possibility to overcome political economy problems. Potrafke and Reischmann (2014) test sustainability of German Laender finances using this approach and find out that they are sustainable if the German fiscal
equalization system is considered, while Feld et al. (2018) suggest that they only partly meet the criteria for fiscal sustainability even in the case with fiscal transfers.

The third test strategy follows a structural approach using Dynamic Structural General Equilibrium (DSGE) Models (D’Erasmo et al. 2016). Economic growth and interest rates are endogenous in these models. The endogeneity of interest rates to the fiscal and the economic situation of a country is reflected in the expectations of market participants. If theoretical arguments are taken seriously, in a situation of interest rates higher than GDP growth, a government cannot redeem its loans by issuing new debt forever. If market participants doubt the repayment of a country’s loans, potential creditors only hesitantly buy government bonds inducing interest rates to rise, leading to further creditors to withdraw and so on (Calvo 1988, Morris and Shin 1998). It is obvious that the possibility for a state to play a Ponzi game is restricted and depends on its credibility. If credibility is lost, financial markets quickly switch from a situation in which government finances look sustainable to a situation with skyrocketing refinancing costs and fully unsustainable finances. This credibility rests on political economy and institutional environments.

4. **Explanations of Public Debt**

Given this pattern of the development of public debt across OECD countries and the discussion of the sustainability of public debt, it is important to find out what are the economic and institutional factors explaining public debt and thus shape its sustainability. For Buchanan (and many other public choice scholars), based on experience with public debt in OECD countries at earlier times (Buchanan 1968, 1997, Buchanan and Wagner 1977), it may have been obvious that the evidence alluded to in the previous two sections supports the notion of excessive indebtedness. His Keynesian critiques would however hold that much of the movements of public indebtedness are due to the cyclical movements of the economy and are needed to contribute to economic stabilization.

Can cyclical movements indeed explain the variation of public debt of OECD countries across time and space? Standard textbook knowledge suggests that business cycles certainly play a role, at least when the built-in-flexibility of government budgets is allowed to work. In a recession, public revenues decline and expenditures increase. A recession involves less aggregate income of an economy, hence less (personal and corporate) income tax revenue and social security contributions. On the spending side, higher unemployment rates, for example, trigger higher aggregate spending for the unemployed if there are unemployment insurance
schemes. Usually, such automatic stabilizers are supposed to work without the government trying to counteract them with tax increases or spending reductions, as this would potentially deteriorate the economic situation further. Moreover, the extent of automatic stabilizers is different in different countries. European welfare states have more automatic stabilization at their disposal than the U.S. for example.

A recent prominent explanation of the variation of public debt across time and countries consists in financial and banking crises. Schularick and Taylor (2012) provide evidence that such shocks play an important role for cyclical movements. In contrast to other demand or supply shocks, banking crises are frequently accompanied by longer periods of moderate economic growth because the consolidation of the banking sector takes time.

Another obvious reason for higher government debt consists in singular events that hit a country like a purely economic shock. Wars and violent conflicts belong into this category as do natural disasters like, e.g., earthquakes, extreme weather events, floods or draughts. In the case of Germany that featured as an illustrative case in previous sections, unification of West and East Germany in 1990 was such a singular event leading to an increase of debt because of immediate financing requirements that would have been difficult to obtain via tax increases.

Other traditional explanations for public debt are public investment and demographic change. According to the golden rule of public investment, a government should finance its investment projects with debt because the resulting public infrastructure serves future users as well. A distribution of the costs of public infrastructure across time requires future users to pay their fair share of an infrastructure that is useful for them. The golden rule actually is a normative argument like the recommendation to let automatic stabilizers work. Both additionally provide positive explanations regarding the extent to which public debt can be explained by business cycles and public investment. In the case of demographic change, the positive question dominates as to whether ageing societies are under pressure to finance larger parts of social security with higher indebtedness. Given that demographic change will mainly take place in future decades in most OECD countries, with the notable exception of Japan, it has probably less explanatory power for past public debt increases.

Empirically, these traditional economic approaches explain the increasing trend of government debt and its variation across countries to some extent. In particular, economic shocks in the sense of cyclical movements, singular events or banking crises are important explanatory factors. This does not hold with respect to public investment. The increasing
trend of public debt since the 1970s is accompanied by a decreasing trend in public investment in most OECD countries. Demographic change has some explanatory power in the case of Japan, but less in other countries in which ageing sets in later.

Still, such explanations of the variation in public debt are incomplete. In particular, the question emerges as to why public debt increases in recessions or due to singular events, but is not reduced in booms or when the economic effects of singular events are overcome. What are the factors preventing a government from consolidating its budget in better times? Buchanan and Wagner (1977) hold Keynesianism responsible for excessive indebtedness. In the early days of Keynesian macroeconomic policy, when the U.K. and the U.S. endorsed it in the 1950s and 1960s, the effects on public debt were still low, partly because of relatively high inflation in both countries, partly because of overall stronger economic growth. When Keynesian recipes were applied in the 1970s, after the breakdown of the Bretton Woods system, stagflation emerged, showing how such policies can fail, also giving way to the increasing debt dynamics shown in Section 2. However, this reasoning is also incomplete as it is particularly the lacking consolidation in good times that requires an explanation. Keynesianism may have abolished the informal (moral) rules of sound fiscal policy that existed before and thus provided the general environment for profligacy (Buchanan 1985, 1987). As an explanation for actual debt variations it is insufficient.

This leads to the more recent analyses in political economics. Alesina and Pessalacqua (2016) provide a comprehensive survey on the political economy of government debt. They ask whether the observed pattern of government indebtedness is excessive. Optimal debt is obtained on the basis of tax smoothing that proposes to cope with transitory shocks by allowing for budget deficits instead of tax rate changes in order to minimize the excess burden of taxation (Lucas and Stokey 1983). Alesina and Pessalacqua (2016) conclude that optimal debt theory is not supported by the data implying that government debt is excessive, i.e., there is a deficit bias in fiscal policy. Consequently, they consider different arguments from political economics to close the explanatory gap between actual (excessive) debt and optimal debt levels.

Without providing a comprehensive account, two different political forces play a particularly important role: Elections and common pool problems. Elections could have two different effects. On the one hand, governments have incentives to spend before elections in order to ensure voter support (see, e.g., De Haan and Klomp 2013, Foremny et al. 2018). After elections, some of this additional spending is partly compensated for by a budget
consolidation that is however weak, for example, because of tax resistance. Overall, public debt may increase across time. On the other hand, governments may act strategically before elections. Anticipating that it is probably not reelected, a governing party may leave its successor less fiscal space restricting its ability to keep its election promises, hence increasing reelection of the current governing party at the next election (see, e.g., Pettersson-Lidbom 2001). Strategic government debt may require highly rational policy-makers, but it can also potentially explain increasing trends in public indebtedness because excessive debt of the current government to bind the next government does not prevent the latter from trying to keep as many of its election promises as fiscal space allows.

Common pool problems are another powerful public choice explanation of excessive public spending and public debt. The basic idea is going back to Buchanan and Tullock (1962), but is more fully examined by Weingast et al. (1981) regarding spending and Velasco (1999, 2000) regarding public deficits and public debt. A common pool problem emerges if different groups have access to a common resource, in our case the budget, and try to obtain as many favors as possible. Each group exerts its demand for public funds until the marginal benefits of obtaining such funds equals the marginal costs of the financial contribution of the group to the budget. A spending bias emerges because some groups have better access to the budget than others such that benefits are concentrated and financing costs are distributed over a larger population. Improved access is obtained through log-rolling between legislators or coalitions between parties. If the financing of current spending that triggers benefits for those groups can be spread to future taxpayers who cannot participate in today’s decisions, the incentives for excessive spending may even be higher. Such excessive spending is accompanied by excessive indebtedness. Moreover, this reasoning offers a particular twist regarding fiscal consolidation. In case, a government wants to consolidate the budget, the different beneficiary groups will oppose it and obstruct the consolidation goals.

The common pool problem has different faces. It might be the result of log-rolling between legislators in parliament, an exercise common in U.S. Congress, but frequently present in other political systems too (for the not fully conclusive evidence, see, e.g., Egger and Köthenbürger 2010 versus Pettersson-Lidbom 2012). The role of fragmented government is also discussed regarding coalition governments (Roubini and Sachs 1989a, b, De Haan and Sturm 1994, De Haan et al. 1999) or regarding cabinet size (Perotti and Kontopoulos 2002, Schaltegger and Feld 2009a, Fritz and Feld 2015). In the previous case, the coalition treaty between the government parties is a form of explicit log-rolling. In the latter case, each
spending ministry induces the overuse of the fiscal commons while the finance ministry is supposed to have a gate-keeping role.

Buchanan (1997, pp. 497) summarizes the basic problem why ordinary politics cannot balance the budget formidably:

“Government spending for a wide array of “goods” may be authorized, and every one of these “goods” may be valued positively by some or all constituents. The approval of these rates of spending may, however, proceed without explicit regard to the genuine opportunity cost that must ultimately be measured in the sacrifice by someone, sometime, of other values that might have been produced. It is not the public spending, as such, that is the proper focus of attention here. ... That which makes the existing rules generate patterns of outcomes that we deem to be irresponsible is the political agents’ authority to spend without taxing. Little or no sophistication is required to recognize how different the dynamics of the fiscal choice would be in a constitutional setting that forced politicians to levy taxes to cover outlays.”

He further emphasizes again that the opportunity costs of public spending are shifted to future generations because those who give up resources today, i.e., the lenders do so in exchange for valued claims, e.g., government bonds, against future taxpayers, who will have restricted fiscal space to serve their own spending needs. The interaction between burden shifting of government debt, with which Buchanan’s analysis started 60 years ago, and the political economics of public debt is obvious from these quotes. The conclusion that must be drawn from this analysis is also straightforward: The constitutional setting must be changed.

5. Institutional Restraints on Public Debt

If public choice mechanisms are a reason for the deficit bias in fiscal policies, institutions must indeed play a role for the variation in public debt to GDP ratios that is observed across time and countries. Moreover, institutions should affect the expectations of financial markets regarding the sustainability of public debt in the sense that a country is willing and able to service its debt. Such reasoning offers chances for positive analysis, but also leads to the normative question as to how a democratic regime should be designed in order to induce sound fiscal policies.
The first step of such a positive analysis is a comparison of public debt between different constitutional systems. Persson and Tabellini (2003) hypothesize the different incentives in majoritarian vs. proportional representation systems and in presidential vs. parliamentarian democracy as well as the interactions between these regimes. They argue that public debt will be higher in parliamentarian and proportional representation systems because these systems favor broad-based redistributive systems and higher political rents. The evidence regarding differences between these systems is however inconclusive as, e.g., neither Funk and Gathmann (2013) nor Pfeil (2017) can support their analysis. A reason may be that log-rolling and pork-barrel politics may be similarly strong, though different in those systems.

The evidence is much more conclusive regarding the comparison between direct and representative democracy. The literature focuses on the effects on particular referendums, for example, the Swiss fiscal referendum as a veto instrument. If spending exceeds a certain threshold, a fiscal referendum must be held. The type of spending that usually induces such fiscal referendums is investment spending which is often financed by public debt. More generally, however, the possibilities for log-rolling and pork-barrel politics are lower in referendums and initiatives as compared to parliament. It is thus no surprise that evidence speaks in favor of a lower deficit bias in direct democracy (Kiewiet and Szakaly 1996, Feld and Kirchgässner 2001a, Blume et al. 2009, Feld, Kirchgässner and Schaltegger 2011).

Federalism vs. unitarianism provides for another prominent system comparison. The difficulty in that comparison results from the many characteristics of the different federalisms around the world. There are systems of cooperative federalism in which tax and spending responsibilities are not properly assigned such that liability and control deviate at the different government levels. An example is Germany with its strongly egalitarian fiscal equalization system, highly centralized taxing and decentralized spending powers. In systems with taxing and spending powers assigned to each level of government, a stronger fiscal competition results. Such types of competitive fiscal federalism do not restrict consolidation efforts of governments and have lower public debt (Schaltegger and Feld 2009b, Foremny 2014, Asatryan et al. 2015).

Aside from these overall system comparisons, fiscal rules figure prominently in the discussions about institutional constraints on excessive spending and excessive indebtedness. The early literature on balanced budget rules in the U.S. is ambiguous with respect to its spending effects (Kirchgässner 2002), but more conclusive regarding public debt (Bohn and Inman 1996, Burret and Feld 2014). These early analyses on the effects of fiscal rules show
that much depends on their design. Simple rules, rules that are too crude, offer many possibilities to circumvent them (von Hagen 1991). Bohn and Inman (1996) have thus offered a list of characteristics of balanced budget rules in the U.S. that seemed to have worked. One such characteristic is that they are fixed at the constitutional level, a proposal that Buchanan has supported again and again.

Similarly, the more recent discussion about second generation fiscal rules asks for sophisticated rules, like the Swiss or German debt brakes (Eyraud et al. 2018). Both fiscal rules, having a broad coverage in general, require an (almost) balanced budget across the business cycle, i.e., structural budget balance, such that automatic stabilizers are allowed to work. They allow for well-defined escape clauses as additional, but clearly defined exceptions to the rule in which deficits may be higher. Budgeting mistakes are accounted for on a separate adjustment account and must be balanced after a certain time. And, following Buchanan (1997), they do not allow for deficits to cover investment spending.

The Swiss federal debt brake has been inspired by cantonal fiscal rules that effectively restrain cantonal public debt (Feld and Kirchgässner 2001b, 2008, Krogstrup and Wälti 2008, Burret and Feld 2018a, 2018b). Feld et al. (2017) provide evidence that these cantonal debt brakes, in addition to the credible no bailout clauses, reduce risk premia of the Swiss cantons. Pfeil and Feld (2016), using the Synthetic Control Method, present evidence that the Swiss federal debt brake reduced the cyclically adjusted budget balance. In a meta-analysis, Heinemann et al. (2018), considering 25 studies with 889 observations, show that fiscal rules have a significantly negative correlation with primary deficits and budget deficits. Overall, this broad research outcome strongly supports Buchanan’s (1997) claim for a balanced budget amendment.

6. Conclusion

James Buchanan pioneered the political economics of public debt. Buchanan (1958) was concerned with a shifting of the debt burden to future generations, Buchanan and Wagner (1977) accused Keynesianism of being responsible for fiscal profligacy. Keynesian follies undermined the informal (moral) rules of fiscal prudence that prevailed before the Keynesian revolution set in (Buchanan 1985, 1987). Buchanan’s (1997) conclusion was straightforward: Informal rules that shaped fiscal policy in many countries until the 1960s should be replaced by formal rules, i.e., balanced budget amendments to constitutions or, in general, fiscal rules.
In this paper, we have traced the development of public debt in OECD countries across time raising first concerns of excessive indebtedness in those countries. A discussion of the sustainability of public finances indicates that there is a shift of public debt to future taxpayers in particular when they face the danger of financial markets withdrawing their confidence in a country’s willingness or ability to pay. There are traditional economic reasons for public debt (business cycle, public investment, particular single events (unification, natural desasters)), but they cannot explain lacking consolidation in better times. Two political-economic explanations particularly add to the understanding of excessive debt: Elections and common pool problems. Institutional rules influence whether such political economics mechanisms more or less severely affect fiscal policy. According to the recent evidence, well-designed fiscal rules help to obtain sound public finances.

In sum, it seems as if Buchanan’s thinking about public debt had finally convinced policy-makers and constituencies around the world. Many countries, in particular in Europe, have introduced fiscal rules or improved existing rules. However, Leviathan lives on and particularly fights back since the Great Recession. Anyway, I found out that Jim Buchanan was in a good intellectual neighborhood to one of the leading classical liberals in Switzerland in the 19th century. In his book, Weltgeschichtliche Betrachtungen Jakob Burckhardt (1921, p. 132, my translation) wrote: “We should anyway shut up against the middle ages, as those times did not bequeath public debt to their successors.“

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Lars P. Feld has been chair of Economic Policy at the Albert Ludwig University of Freiburg since 2010 and is the current director of the Walter Eucken Institute. After his studies in economics at the University of Saarland (Germany), Feld graduated from University of St. Gallen in 1999 and qualified for a professorship in 2002. From 2002 to 2006, he worked as a professor of economics, with a focus on public economics, at the Philipps University of Marburg, and from 2006 to 2010 at Heidelberg University.

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Feld has been, since 2003, a member of the Scientific Advisory Council to the Federal Ministry of Finance, Germany, and, since 2011, a member of the German Council of Economic Experts (GCEE). He currently represents the GCEE in the Independent Advisory Council of the Stability Council. In 2017, he received an honorary doctorate from the University of Lucerne in Switzerland.
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