

Costly Escape from Fiscal Rules: The Political Economy of Implementing Extraordinary Debt Repayment Clauses

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- **EDRC:** Mandates that excess debt above the rule's limits, incurred after activating the escape clause, **must be paid back within six years.**
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- **EDRC:** Mandates that excess debt above the rule's limits, incurred after activating the escape clause, **must be paid back within six years.**
 - **Costly!**
- **Halac and Yared (2022, ECMA):** When enforcement of rules is limited (possibility of rule suspension, etc.), Swiss-type fiscal rule is socially optimal.

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 - ① Politicians have **conflicting preferences** over the allocation of funds.
 - ② Politicians have **time-inconsistent (present-biased) preferences**.

Model: Periods and Politicians

- **Four Periods:** Represented by $t \in \{0, 1, 2, 3\}$
 - Period 0: "Constitutional stage" where an EDRC can be implemented.
 - Periods 1, 2, and 3: Government receives tax revenue and produces public goods.
 - Period 1 only: Public goods can also be financed with *debt*, and all debt must be paid off by end of period 3.

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- **Two Politician Types:** A and B , with conflicting preferences for public goods.
 - Type A politicians: Prefer g_A
 - Type B politicians: Prefer g_B

Model: Shocks

- **Start of period 1: Negative shock hits, depressing tax revenue**
 - Type is realized in period 2.
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- **Negating a potential structural shock**
 - With sufficient expenditure in period 1: Lasting effects of a structural shock can be **negated** - tax revenue *recovers instead*.
 - Important: Must activate escape clause to engage in this higher (debt-financed) expenditure
 - Essentially *insurance* against a structural shock

Example: Worry About a Structural Shock

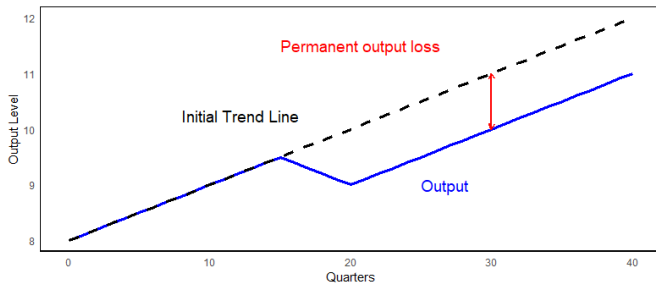
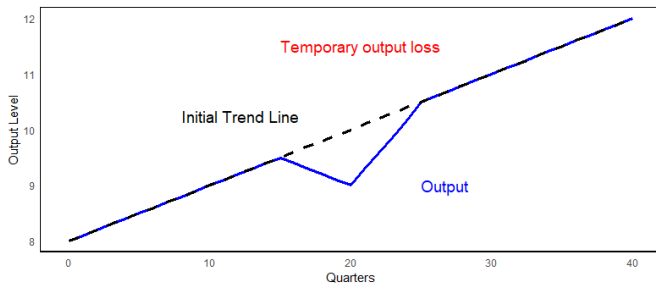
May 13, 2020 - Economy

Fed chair Powell warns of "lasting" economic damage without more stimulus



Courtenay Brown

Avoiding Permanent Output Loss from Structural Shock



Model: Shocks cntd.

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 - Politicians are organized into Parties, denoted A and B, to reflect the types of politicians in each Party.
 - The Party with a **majority** in legislature can allocate funds.

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 - The Party with a **majority** in legislature can allocate funds.
 - But: Escape clause activation requires a pre-determined **supermajority**
 - Important for political conflict - *minority can sometimes block majority*.
 - Therefore: Parties have a different "**threshold probability**" - the minimum value of q for a Party to want the escape clause activated.

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 - ② When Party A or B obtains a majority - everyone is worse off due to reduced debt smoothing.
 - ③ When Party A obtains a supermajority - because now the EDRC deters THEM from activating the escape clause when they otherwise would.

Conclusions

- **One takeaway:** Without additional flexibility, an EDRC is *unlikely to be adopted* in other countries given its costs.
 - Mainly after “true” emergency (GFC, Covid, etc.)
 - Tension over EDRC costs: Switzerland incurred extraordinary debt during Covid, but *extended the repayment timeline* to 2035.
 - Is credible commitment possible here? Other mechanism needed?

News [Swiss Politics](#) ›

Swiss government aims to pay back
Covid-19 debt by 2035