The Puzzle of Weak Fiscal Rules: Time Inconsistency, Political Incentives, and Asymmetric Information

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Introduction

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    - Exempt categories of spending (investment, military, etc.)
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    - Major reason: *Weak design*
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        - Many others...
- **Research Question: *Why are these rules so often weakly designed?***
    - Badinger and Reuter (2017) explicitly note the lack of a choice theory for fiscal rule design strength
    - The standard view of fiscal rules can't explain the existence of weak rules.

Related Literature and the Puzzle of Weak Fiscal Rules

- **Yared (2019)**
  - "Every political explanation for rising debt discussed [here] is based on **time-inconsistency in government preferences**. Current governments want to be fiscally irresponsible while simultaneously hoping that future governments be fiscally responsible. Thus governments across the world have sought to adopt fiscal rules... to **restrict future fiscal policy** and curtail the increase in government debt".

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- **Why aren't rules stronger to meaningfully restrict those future governments?**
  - "Puzzle of weak fiscal rules"
  - Goal: Propose a resolution to the puzzle

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- **Third component: Asymmetric information**
  - Rational ignorance exacerbated by complexity of rules
- **Modeling goal**: When would an opportunistic politician pass a weak rule in equilibrium?

Equilibrium and Takeaways

Main Equilibrium of Interest

- Separating equilibrium where principled politician chooses a strong rule and opportunistic politician chooses a weak rule
- Can be maintained as a PBE if and only if:

$$2E < (1-\gamma)(2E+\delta)$$

- **Main tradeoff of a weak rule for a politician:**
  - Potential political benefit of being able to cater to fiscal policy preferences of future voters, versus. . .
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  - Potential political cost of weak rule strength being discovered by present voters.
- **Therefore, main factors determining rule strength are:**
  - Size of political benefit, political transparency, size of ego rent E, and probability that politician is principled.