[Fiscal Rules and Market Discipline]

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Fiscal rules have proliferated as a way to limit public debt. Rules intend to impose fiscal discipline on governments that might be otherwise present-biased. However, lenders also discipline government borrowing through a market mechanism, with excessive debt penalized with higher interest rates. In this paper, we study the interaction between fiscal rules and market discipline in limiting government borrowing.

We present a model with asymmetric information about governments' fiscal responsibility: their propensity to borrow and default on public debt. A government's borrowing rates are determined by financial market participants' expectations about the government's fiscal responsibility. This gives governments the incentive to reduce their borrowing so as to signal their prudence. Political economy pressures may lead extravagant governments to borrow excessively relative to citizens' preferences. But the desire to maintain the favour or financial markets provides a countervailing incentive. In fact, we show that government may end up in some circumstances under-borrowing to signal their prudence.

In these circumstances, fiscal rules play a more subtle role than previously appreciated. They do indeed achieve the desired objective of restraining extravagant or present-biased policymakers from overborrowing. However, restraining extravagant policymakers makes it more difficult for prudent policymakers to signal their fiscal responsibility. These may then need to restrain borrowing even further—imposing excessive austerity—to distinguish themselves from their less-responsible counterparts.

We then characterize the optimal borrowing limit. The optimal rule balances the trade-off between restraining present-biased policymakers and the perverse externalities this imposes on more prudent policymakers. We show that an optimal rule will always restrain the more irresponsible government, but will never be so tight as to naively push governments to "do the right thing".