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How Does a Budget Rule Affect Sovereign Default Incentives and Welfare?

(Job Market Paper)

Over the last 30 years, a steadily increasing number of small open economies have adopted fiscal rules. Employing a fiscal rule affects sovereign default probability and the welfare of the households. This paper analyzes the role of a fiscal rule in the sovereign default literature. Following the Eaton-Gersovitz sovereign default model where the government makes decisions to maximize households' utility, I enrich fiscal features in the model by adding a budget rule. I solve the nonlinear DSGE model quantitatively to examine how a fiscal rule affects the likelihood of debt repudiation and the welfare of households. My model is calibrated to Colombia. Colombia enacted a structural budget balance rule in 2011 that ensures spending cannot increase unless tax revenue increases, which reduces households' private consumption. My model can be applied to any small open economies with sovereign default risk.

The first contribution is to show how a budget rule lowers default incentives. Because a budget rule ties government spending to taxes, if more revenue is raised through borrowing, less room is left for tax revenue, forcing reduced government spending. This mechanism makes borrowing more costly because it reduces government spending from which the government derives utility. The country stays in a low debt equilibrium, reducing default risk and sovereign bond spreads. This result reproduces Colombia's experience after it adopted the rule. Adding a low-cost financing option from international institutions, which a country can access only if it has fiscal discipline, reduces risk-premia further. Cheaper loan opportunities from a third party provide insurance to bondholders, raising sovereign bond prices and ensuring a lower default rate.

My second contribution shows how the budget rule improves households' welfare measured by a permanent increase in present value consumption. Although the rule constricts the choice set of the government resulting in a sub-optimal allocation, it can improve households' welfare if it addresses inefficiencies from an agency problem. An agency problem emerges when households' welfare depends on government choices, but the government does not behave in the best interest of the households. A common example is when the government chooses a higher level of public spending than the households prefer. According to the rule, tax must rise to raise government spending , leading to reduced consumption. The budget rule improves households' welfare by limiting public spending.

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