

THE LIMITS OF POLITICAL COMPROMISE: DEBT CEILINGS AND POLITICAL TURNOVER

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Abstract

We study the desirability of limits on the public debt and of political turnover in an economy where incumbents have an incentive to set public expenditures above the socially optimal level due to rent-seeking motives. Parties alternate in office and cannot commit to future policies, but they can forge a political compromise where each party curbs excessive spending when in office if it expects future governments to do the same. In contrast to the received literature, we find that strict limits on government borrowing can exacerbate political economy distortions by making a political compromise unsustainable. This tends to happen when political turnover is limited. Conversely, a tight limit on the public debt fosters a compromise that yields the efficient outcome if political turnover is vigorous. Our analysis thus suggests that to sustain good economic policies, a society needs to restrict either the extent of political turnover or the ability of governments to issue debt, but not both. (JEL: JEL: E61, E62, H30, H63)

The editor in charge of this paper was Dirk Krueger.

Acknowledgments: We thank Dirk Krueger (the editor) and two anonymous referees for very useful comments and suggestions on a previous version of the paper. We also thank Paulo Arvate, Braz Camargo, Tiago Cavalcanti, Allan Drazen, Claudio Ferraz, Jon Fiva, Bernardo Guimaraes, Delfim G. Neto, Mattias Polborn, B. Ravikumar, Nico Voigtländer, Rodrigo Wagner and participants at several seminars for helpful comments. And we thank Carlos Eduardo Ladeira for competent research assistance. Cunha and Ornelas acknowledge financial support from the Brazilian Council of Science and Technology (CNPq). Ornelas also acknowledges financial support from the LSE Santander Travel Fund. Ornelas is a Research Fellow at CEPR and CESifo and a Research Affiliate at CEP.

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