Do Fiscal Rules Matter? A Difference-in-Discontinuities Design*

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This version, March 2011

Abstract

We evaluate the effect of relaxing fiscal rules on budget outcomes in a quasi-experimental setup. In 1999, the Italian central government introduced fiscal rules—known as the Domestic Stability Pact—aimed at disciplining the budget management of municipal governments, and in 2001 decided to relax the Pact for municipalities below 5,000 inhabitants. The latter institutional change allows us to implement a difference-in-discontinuities design, which combines before/after and discontinuous policy variation. Our estimates show that the relaxation of fiscal rules translates into a larger deficit and lower local taxes, while municipal expenditure remains almost unchanged. The impact is higher when budget rigidity is high (that is, when personnel expenditure and debt services are a large share of current expenditure) and when mayors can run for reelection. A pre-2001 falsification test shows that our findings are not driven by the fact that municipalities below and above 5,000 are differentially affected by fiscal rules.

*We thank Alberto Alesina, Robert Barro, Raj Chetty, Lawrence Katz, and seminar participants at Bank of Italy, Boston University, Harvard University, and IGIER for their insightful comments. The remaining errors are ours. Financial support is gratefully acknowledged from Catholic University of Milan for Veronica Grembi; the European Research Council (Grant No. 230088) and Bocconi University for Tommaso Nannicini; Harvard Department of Economics, Harvard Multidisciplinary Program in Inequality & Social Policy, and Bank of Italy for Ugo Troiano. Corresponding author: Ugo Troiano, Harvard University, Department of Economics, Littauer Center, 1805 Cambridge Street, Cambridge, MA 02138; e-mail: troiano@fas.harvard.edu.