Public Debt Limits and **Expansionary Fiscal Austerity**: Reallocating Credit to Corporations Amid Fiscal Consolidation

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3ª Conferência “Portuguese Around the World: Central Banking Edition”

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Paper Overview

Research Question: How do subnational public debt limits **associated with** fiscal consolidations impact economic growth and credit allocation?

Identification: Exploit the announcement of the Mexican (FD Law) "Law of Financial Discipline to States and Municipalities" in **April 2016**, then implemented in **March 2017**.

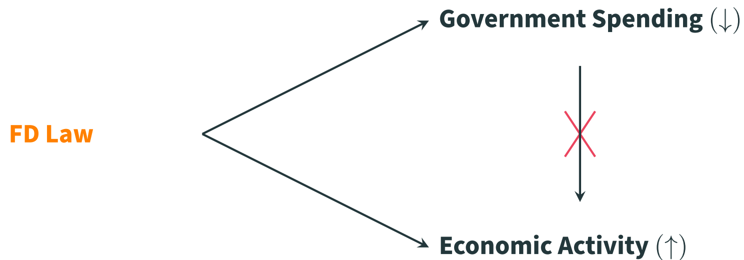
Identification Assumption: Absent this Law, states with lower ex-ante public indebtedness would have followed similar outcome trends to states with higher ex-ante public debt.

Findings. Announcement of FD Law led to:

- **Fiscal austerity** in ex-ante more indebted local governments;
- **Higher extreme poverty rates** likely via cuts in social spending;
- Banks **reallocating credit** from **indebted** local governments to **productive** private firms, **spurring economic activity**.

Comment 1

Is it really about fiscal austerity?



Public Debt is likely Endogenous

Public debt may correlate with unobserved state characteristics affecting outcomes:

1. Despite pre-law parallel trends mitigating this issue, unobserved heterogeneity could still bias results (Roth, 2022);
2. Can we come up with an **identification strategy** that can a) provide clarity on **whether fiscal austerity is expansionary** AND b) **address endogeneity** of public debt?

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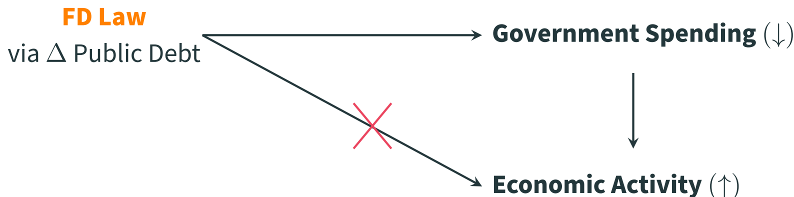

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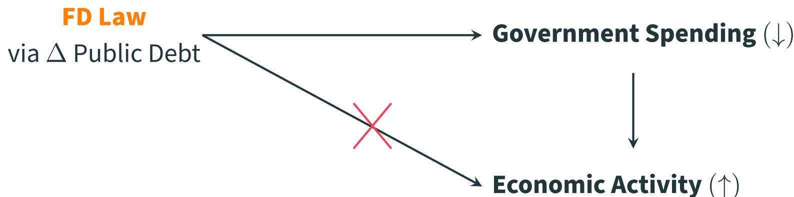

Exclusion restriction: Policy signals fiscal discipline; better governance; nonlinear effects of public debt.

Within-state variation can help

Assumption: The FD Law's debt limits are more relevant at the state level and create differential "shocks" to municipalities based on their reliance on state transfers or fiscal capacity.

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Two-Steps:

1. **First:** Use **FD Law-induced reduction in state debt** as a source of **unexpected** variation in state-level government spending.

2. **Second:** Examine how this state spending shock translates into municipality-level outcomes (e.g., economic growth) using a **Bartik-style instrument**.

Within-State Variation: Municipality-Level Analysis

Bartik Instrument:

$$\text{Bartik}_{m,s} = (\text{State Shock}_s) \times (\text{Pre-Law Spending Exposure}_m)$$

- **State Shock:** Reduction in state-level spending before and after the FD Law.
- Pre-Law Exposure: **Share of state transfers** or spending in a muni's revenue before the FD Law.

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- LHS: change in municipal GDP;
- RHS: change in municipal government spending instrumented by the Bartik instrument;
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Identification assumption: State-level governments do not change spending because municipalities that receive a disproportionate amount of government spending are doing poorly relative to others.

Comment 2

Alternative Story?

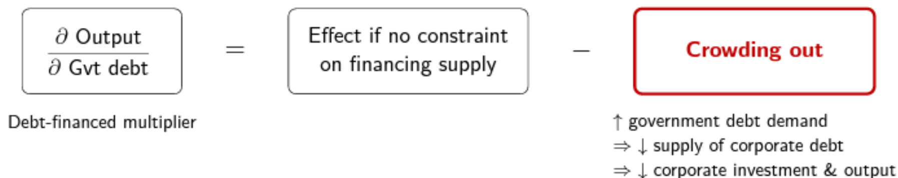

Figure 1: Pinardon-Touati (2024)

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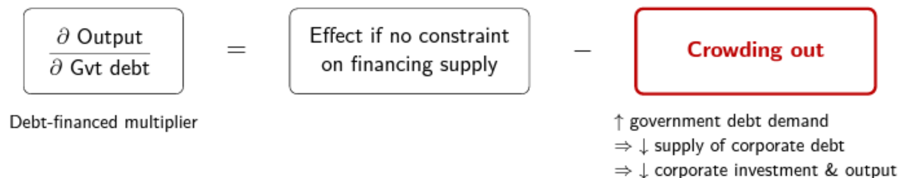

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- Adding **another piece** to the relationship between government debt and output puzzle.
- **Mechanism:** credit reallocation.

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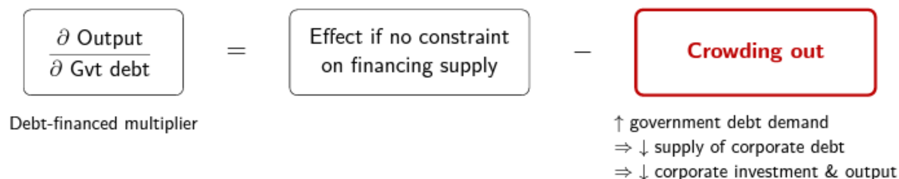

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- Adding **another piece** to the relationship between government debt and output puzzle.
- **Mechanism:** credit reallocation.
- **Innovations:**
  1. Clear policy experiment FD Law with continuous treatment variable;
  2. Unexpected reduction in government debt;
  3. Rich data to disentangle for potential mechanisms.

Fine tunning the mechanism

Key Results on Infrastructure Spending

1. One s.d. increase in ex-ante indebtedness **reduces public infrastructure spending** $\approx$ 19%;
2. FD Law had a greater impact in states with a **lower share of infrastructure spending**. Meaning an *ex-ante* stronger need for private construction(?)

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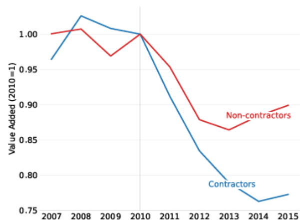
Then, are **banks more exposed** to both **local governments** and (procurement-)**construction firms** before FD Law **more likely to reallocate credit** towards these firms?

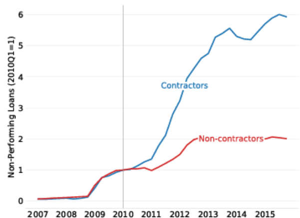
If so, and if these firms are **more productive**, then one could rationalize the **positive relative impact on productivity and economic activity**!

Fine tunning the mechanism: I <3 Procurement

Figure 3: Impact of procurement cuts on firms



(a) Value added



(b) Non-performing loans

For Portugal, Bonfim et al. (2024) show that **procurement cuts** led banks with non-performing loans from government contractors to a **persistent reduction in credit supply to other firms** (which consequently grew less).

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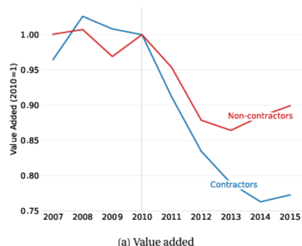

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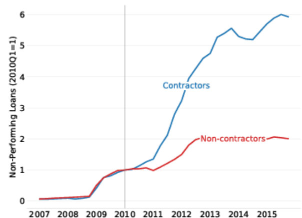

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These NPLs were mostly driven by **procurement-exposed construction firms**.

Story: By relocating credit away from local governments into construction firms, **the debt limit rule might be canceling the negative effect of fiscal consolidations felt by all firms**, while not totally offsetting the negative effects felt by people in extreme poverty.

Other Minor Comments and some cheap shots

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1. Expand on why credit flows toward private firms—risk appetite vs. regulatory constraints?
2. Incorporate additional credit terms (e.g., default rates, loan durations).
3. Explore the role of firm heterogeneity: Are effects stronger for SMEs or specific industries?
4. Include robustness tests using household-level poverty indicators.
5. Why not go to the most granular level at the state-year level? It would be helpful to state the reason why when stating the use of region*year FE.
6. Does it make a difference to use the difference of the actual ratio of total public debt to net income to the law threshold? Possible to do a state-dependent analysis by estimating simultaneously but separate coefficients for states above/below the threshold. Why? There must be some non-linearity.
7. Table 7a, column 1, last coefficient (0.09), check standard error and significance reporting.

Thank you!