

TABLE OF CONTENTS

Introduction	vii
Acknowledgements	xv
PART I: PARTISAN POLITICS AND DEBT	
1 On the Redistributive Property of Budget Deficits (Luisa Lambertini).....	3
2 Parliamentary Dynamics and Fiscal Policy (Alfredo Baldini).....	19
3 Electoral and Partisan Manipulation of Public Debt in Developed Democracies, 1956-90 (Robert J. Franzese, Jr.).....	61
PART II: PARLIAMENTARY INSTITUTIONS, FORMAL BUDGET RESTRAINTS AND FISCAL DISCIPLINE	
4 The Role of Parliamentary Committees in the Budgetary Process Within Europe (Mark Hallerberg).....	87
5 Fiscal Constitutions, Fiscal Preferences, Information and Deficits: An evaluation of 13 West-European Countries 1978 - 95 (Leif Helland).....	107
6 Information and Public Spending: An Empirical Study of Budget Processes in the US States (Rolf Strauch).....	139
7 Fiscal Institutions in US States (Brian Knight and Arik Levinson).....	167
PART III: THREE CASES OF INSTITUTIONAL REFORM	
8 Reforming Budgetary Institutions: Swedish Experiences (Per Molander).191	
9 Institutional Reforms and Belgian Fiscal Policy in the 90s (Georges Stienlet).....	215
10 A Case of Institutional Endogeneity? A Study of the Budgetary Reforms of the Government of Alberta, Canada (Ronald D. Kneebone and Kenneth J. McKenzie).....	235
Index	263

INTRODUCTION

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The large and persistent deficits, rising levels of debt and growing levels of public spending observed in many OECD economies during the past 25 years have stimulated much theoretical and empirical research on the political economy of public finance. Although a number of issues have been studied extensively, certain areas are still at an exploratory stage and need further theorizing and thorough empirical research. During the last two decades, the theoretical debate on budgeting has been dominated by the controversy between partisan and institutionalist approaches. Within the more political-science oriented, institutionalist literature, a controversy exists between the distributive and the informational perspectives, each setting forth a distinctive organizational rationale of parliaments with different fiscal implications.

The papers in this volume cover these different perspectives, extend previous models, and test their empirical validity. The papers were originally written for a conference on "Institutions, Politics, and Fiscal Policy" organized by the Center for European Integration Studies at the University of Bonn, Germany, in July 1998.

The book is organized in three parts each focusing on a distinctive aspect. The first part is dedicated to the partisan perspective. The second part focuses on budget institutions. The third part consists of three case studies of institutional reform of the budget process.

This book is directed to academics and practitioners alike. On the one hand, the papers included in this volume present the current frontier of international comparative research on the role of institutions and partisan politics in public finance. In this regard the book is of interest to the research community studying the political economy of budgeting. On the other hand, practitioners in national ministries of finance and international organizations have been highly perceptive to the arguments and facts generated by this academic debate. Several international organizations set forth corresponding recommendations for national governments and budget officers and some national ministries of finance have adopted important considerations from this debate for their national reform proposals.

Partisan Politics and Debt

Partisan approaches, in general, argue that the cause of public debt accumulation is either party ideology or strategic behavior by political parties trying to curtail the policy space of future governments representing different ideologies. In the first paper, Luisa Lambertini proposes a model where the government may use the tax schedule and the budget balance strategically to improve its chance of reelection. Under progressive wealth taxation, Ricardian equivalence fails, because a budget deficit affects the marginal tax rate on wealth. A conservative government that represents the interests of wealthy individuals and must sway the median voter to be reelected, runs a budget deficit so as to drive the median voter's wealth into a high marginal wealth tax bracket and make him better off under less progressive taxation. Conversely, a liberal or social democrat government that represents the poor and must sway the median voter, runs a budget surplus so as to drive the median voter's wealth into the low marginal tax bracket and make him better off under a more progressive taxation. The model predicts that conservative governments choose less progressive wealth taxation than liberal governments and, when electoral competition is stiff, conservative governments lower taxes and run budget deficits whereas liberal governments raise taxes and run budget surpluses.

In a similar vein, Alfredo Baldini, in the second paper, explores the relationship between the type of government, its fiscal stance and government tenure. Baldini links the parliamentary decision on the budget to a vote on the incumbent government. If these decisions are intertwined and membership in the governing parties determines access to transfers, the amount of transfers which legislators will demand for supporting the government is affected by four elements: changes in the probability of receiving transfers, the discount rate, the distribution of fiscal transfers, and dynamic changes in the distribution of fiscal policies. In more practical terms, the model suggests that the parties' expected utility for voting in favor of the government's fiscal policy increases in the parties' substitutability, in the "tightness" of the budgetary rule and in the shortsightedness of the party. Thus, the model provides an explanation for why multi-party governments in parliamentary democracies and countries with weak budget procedures have been characterized by shorter government tenure and larger deficits. The empirical evidence provided in the chapter partly corroborates the theoretical arguments. Interestingly, Baldini finds that a widening of the primary deficit also leads to shorter government duration, at least for coalition governments. He suggests that the distributive struggle over the relative gains from "loose" fiscal policy may induce parties expecting better pay-offs in a new coalition to break-up the current government. This complements the result of previous research that tight stabilization measures do not necessarily cause the electoral defeat of the ruling government (Alesina et al. 1998).

The political-economy literature seeking to explain public-debt accumulation has grown rapidly in recent years as debt crises have emerged in many nations. While

several different theories have been developed, the empirical evaluation of these theories has lagged somewhat behind. In the third chapter, Robert Franzese joins those beginning to redress the imbalance, operationalizing and evaluating standard electoral and partisan budget-cycle arguments and modern, rational-expectations-strategic variants regarding political incentives to manipulate public debt. The evidence strongly suggests modifications of the former and flatly rejects the latter. The main reason for the latter finding is that strategic models of debt accumulation have by far under-estimated the persistence of debt. Electoral cycles exist, though their timing is different than usually assumed. Strong pre-and -post electoral deficit cycles can be found in the data. Because debt adjusts so slowly over time, changes in the electoral-cycle frequency have sizable long-run effects on the debt level. Partisan effects also exist, but they run in the commonly expected direction (left - deficits, right - surpluses) only when incumbent governments perceive a high risk of replacement by ideological competitors. They run in the opposite direction when risk is low. Again, a partial explanation is provided by the slow evolution of the debt level. Franzese conjectures that right wing incumbents expecting considerable turnover in government may expect to not only constrain their successor but also themselves if they resume office soon. Therefore, they run lower deficits than the standard model predicts. Conversely, a secure right wing incumbent might expect to hold government safely enough to try altering the electorate's partisan preferences by issuing debt. A secure left wing government may be less willing to accept large structural deficits than its right wing counterpart, because the electorate expects a strong reaction to cyclical economic shocks from it. In contrast, an insecure left wing incumbent may be tempted to respond more forcefully even to relatively small economic slumps both because it would lose office more surely if it does not and because it expects that the right will react insufficiently. In this regard, the above mentioned pattern contradicts recent rational-expectations-strategic models but suggests an alternative sort of strategic, partisan manipulation of the budget.

These results are not only interesting from an academic point of view, but also carry a strong policy lesson. The data on which the empirical results are based include periods of relatively low deficits and stable debt levels in the 1960s as well as episodes of large deficits and growing debt levels in the 1970s and early 1990s. In many OECD countries, current fiscal trends resemble more the characteristics of the 1960s. However, the authors pose a compelling warning against any premature hopes that this reflects a permanent shift in economic thinking or party ideologies.

The contributions do suggest some clear ideas about institutional reforms. Franzese's results indicate that prolonging the electoral cycle contributes to lower deficits. Baldini's analysis suggests to increase the costs of breaking up a coalition and of failing to pass a budget law as ways to improve budget performance. Finally, centralizing the parliamentary stage of the budget process in a way to preclude large package deals and universalist decision-making would help to improve budget

performance, particularly in times when the executive is operating under strong fiscal constraints and wants to push forward tough budget decisions.

Parliamentary Institutions, Formal Budget Restraints, and Fiscal Discipline

The chapters by Hallerberg, Helland, and Strauch bridge the gap between two prevailing approaches to analyzing parliamentary institutions, the distributive and the informational approach. The distributive perspective posits that committees are established to guarantee deals made among legislators to distribute spending across different policy areas. The informational perspective in contrast contends that committees are designed primarily to provide information to the legislature at large. Whereas the former has already received widespread attention in the literature on budgeting, relatively scant evidence exists for the latter outside the US Congress. The chapters provide theoretical arguments and cross-sectional evidence on institutional choices as well as budgeting behavior in European countries in line with this informational approach.

Mark Hallerberg opens this part analyzing the information structure of the budget process. Building upon Mattson and Strøm (1995), he considers why differences in the organization of the committee system exist across European parliaments. He argues that the key difference concerns the regularity of one-party versus multi-party governments. In countries that experience one party governments regularly, weak committees develop that have neither the power to make significant changes to government bills nor to collect information about the compliance of the ministers. In countries where coalition governments are common, however, committees will be more likely to be strong information providers because they are a forum for coalition partners to monitor each other. These patterns are particularly apparent when one examines the budgetary process.

Leif Helland reconsiders the existing empirical evidence for the fiscal effect of distributive institutions. He argues that this approach bluntly overlooks an important function of the committee system and sets forth the benefits of information provided by parliamentary committees. Using also the conceptualization of Mattson and Strøm (1995) for the agenda-setting power of parliamentary committees, he tests the hypothesis that more powerful committees provide better information and, hence, increase fiscal discipline. The cross-sectional evidence suggests that powerful committees are, in fact, associated with lower deficit levels. Moreover, he refines earlier comparative work on budgeting in European countries. Helland studies the impact of executive and parliamentary ideology on the effectiveness of institutions to contain the deficit bias at different stages of the budget process. The empirical evidence found for a sample of European countries leads him to conclude that strong prerogatives of the minister of finance or the prime minister in cabinet negotiations and restrictive

parliamentary institutions help to reduce the deficit bias. The effect is enforced if the executive and the parliamentary median have a rightist orientation.

While the information provided in the budget process and distributive implications of budgetary institutions are independent of each other in Helland's analysis, Rolf Strauch considers explicitly the complementarity of these budgetary structures. According to the public choice argument on slack resources, information asymmetries between policy-makers and bureaucrats lead to inefficiencies and overproduction of public goods and services. Strauch combines this argument with the contention of the distributive approach that spending prone policy-makers have a higher demand for public services than the "guardians of the purse", i.e. the political leadership and the minister of finance who have an encompassing interest in the budget. Based on aggregate and disaggregate spending data for the US states from 1987 to 1992, he shows that a powerful governor or legislative leader is in a better position to enforce budget discipline the more information on the costs and effects of public service production they have. Studying different spending categories, however, he finds that information seems less effective for expenditures, such as public welfare programs, where it is hard to define and measure productivity.

Although the contributions to this part of the book are written as positive analyses and do not relate to the more normative New Public Management literature (NPM),¹ implications are obvious. The NPM approach puts much emphasis on the design of supervising institutions and the measurement of performance in the public sector. While a considerable amount of institutional solutions has been proposed and some, primarily anecdotal evidence has been gained about the effectiveness of these measures, little systematic results are available on the net costs of these measures. Using aggregate fiscal data, Strauch's and Helland's contributions indicate that the effort of information gathering and processing is worthwhile because it helps to reduce "budgetary slack". The studies, more specifically, suggest that such efforts should be concentrated on those resource flows, where efficiency is easier to measure and standards of evaluation may be clearer. More importantly, and here the two authors concur with Hallerberg's analysis, it is important who receives the information. Appointment mechanisms must ensure that committees are not exclusively staffed with "high demanders", the members of the monitoring entity must have an incentive and the power to affect decisions. Finally, they must have organizational opportunities for specialization. Congruent jurisdiction of ministries and committees support the creation of expertise in the committees. Other organizational devices are efficiency and productivity studies by the government and the legislature as well as auditing reports.

¹ See among others Osborne and Gaebler's (1992) popular work "Reinventing Government", OECD (1997), and Premchand (1993).

Brian Knight and Arik Levinson analyze the causes and economic consequences of formal budget restraints. Although a lot of evidence exists concerning the impact of budget restraints such as expenditure limits and balanced budget requirements, several methodological problems have remained unaddressed. Specifically, Knight and Levinson discuss the consequences of the possible endogeneity of institutions, and their interactions with each other for empirical research. In the context of new and recent empirical evidence, the authors develop econometric techniques to solve each problem separately, and discuss the difficulties inherent in attempts to solve both simultaneously. They show, first, that formal budget rules "work": careful empirical analysis detects the effects of tax and expenditure limits as well as balanced-budget requirements in their strict version.² This finding is encouraging for policy-makers pondering the effectiveness of formal fiscal restraints e.g., in the European Union. To some extent, however, this result depends on the specific characteristics of the rule. Rules not targeting final budget results are less effective. Moreover, restraints addressing only a fraction of public finances may lead to unintended substitution effects. Thus, rules have to be carefully designed. Second, fiscal restraints should be supplemented by other institutions shaping the decision-making process or enforcing compliance. The authors point towards supermajority requirements as a decision-making rule lowering the propensity to impose higher taxes. Third, the results indicate that fiscal restraints are costly in terms of diminished fiscal flexibility and, as a consequence, disadvantageous macro-economic effects. However, this "defect" of formal fiscal restraints can be mitigated by adequate supplementary institutions, such as a rainy day fund with mandatory contributions.

Three Cases of Institutional Reform

Three in-depth case studies describe the budgetary reforms in Sweden, Belgium and the Canadian province of Alberta. Per Molander discusses the reform of the Swedish budget process during the period 1992-96. The reforms were initiated to overcome a perceived deficit bias, myopia and the importance of "non-decision" related to entitlements. They strongly relied on target setting to enforce the collective rationality of budgetary decisions. Molander identifies several economic and political causes contributing to the success of the reform. In particular, he points out that the existence of economic crisis was helpful, but not sufficient to carry forward the reform project.

Georges Stienlet provides a study of the Belgian budgetary reform. Stienlet first gives an overview of the financing system and the institutional framework of the federalization process in Belgium entering in a decisive stage at the end of the 1980s. At this stage, on the one hand, regions were endowed with discretionary power over their budgets and, on the other hand, a gradual transition of a needs

² See the overview of Poterba (1996) for a similar conclusion.

oriented grant system to a revenue sharing and equalization system over the next ten years was planned. The pre-existent High Council of Finance was reformed and revitalized to provide a platform for the guidance of fiscal policies during this transition process. Later on, the Maastricht convergence process forced Belgian governments to tighten their fiscal policy. The role of the High Council of Finance was strengthened through the convergence process because it monitored the compliance with the announced convergence plan and made recommendations for policy action. The practical working of the High Council is described in detail for the period from 1990 to 1997. Although Stienlet argues that the Council has been very helpful institutional underpinning of the fiscal consolidation in the 90s, the effectiveness of the institution has been hampered by a lack of consistent and fully transparent concepts and methods to assess national and regional public finances.

Ronald Kneebone and Kenneth McKenzie study the budgetary reforms implemented in Alberta in 1993. The authors examine the response of the Alberta government to exogenous shocks to its revenues and expenditures during the period from 1966/67 to 1992/93. They find evidence that pre-reform governments responded to external shocks in an asymmetric manner. The asymmetric response to a series of positive and negative shocks beginning in the mid-1980's led to a perceived 'fiscal crisis' which came to a head in the early 1990's. The newly elected governor Klein then forcefully pushed forward institutional reforms, above all the Deficit Elimination and the Balanced Budget and Debt Reduction Act, as well as fiscal consolidation measures. In the aftermath of the reform, the government did not fall back into the budgeting behavior of previous administration when the crisis vanished.

These three episodes of institutional reform share some important commonalities, which perhaps are to be considered as critical "ingredients" for a successful reform process. First, economic or political circumstances created the urgent need to act. As the first two cases illustrate, the momentum gained in "bad times" is not the adverse situation *per se* but the public perception of a crisis and a general agreement on its main causes among the citizens and the politicians. Second, the development of a viable solution. Viability here relates to the political conditions under which the reformed institutions will have to be effective. This aspect is most obvious in the Belgian case, where the newly gained regional freedoms and the danger of partisan collusion prohibited the imposition of a central monitoring entity directly related to the central government apparatus, and an institution of a more federal flavor had to be found. In the Swedish case, the institutional solution fits nicely into the more general argument about the adequacy of different budget institutions in government systems developed by Hallerberg and von Hagen (1999). Third, a successful reform project needs political protagonists from within the government or at least close to the center of political decision-making. In the Swedish case this was a group of high ranking civil servants and a parliamentary commission working on this issue. In Alberta the strengthening of the treasury and

the tie between the newly elected governor and his treasurer helped to push the reform project through. In Belgium the central bank as a powerful actor strongly pressed for an adequate institution to restrict regional debt financing requirements. Although the role of protagonists seems self evident, it is more complicated for them to prevail than it may appear at first sight. In this regard, leadership and personality are important variables.

Overall, the research presented in this volume confirms that government fiscal policies cannot be fully understood without regard to institutions and politics. Conventional economic models that present fiscal policies as the outcome of maximizing some social welfare function present a useful reference for judging fiscal performance. Actual fiscal policies, however, are shaped by distributional interests and constrained by institutional characteristics of the budget process in important ways. The papers collected in this volume represent a significant step in an exciting research agenda aiming at increasing our understanding of fiscal policies.

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The Center for European Integration Studies (ZEI) was established in 1995 as an applied research institute at the University of Bonn. ZEI is a unique institution in Germany's university scene. It endeavors to bridge the gap between academia and public policy and business, and to contribute constructively to the solution of the political, institutional, and economic challenges of European integration and Europe's long-term development. As an interdisciplinary institute, ZEI emphasizes policy-oriented and empirical work as well as political economy.

Bonn, September 1999

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