

Fiscal Rules, Fiscal Institutions, and Fiscal Performance

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I INTRODUCTION

Public spending is a story of some people spending other people's money. In modern democracies, voters elect politicians to make decisions about public spending for them, and they provide the funds by paying taxes. Two aspects of this story are worrying and have received considerable academic interest in recent years. The first is that public spending involves delegation, and, hence, principal-agent relationships. Elected politicians can extract rents from being in office, i.e., use some of the funds entrusted to them to pursue their own interests, be it outright in corruption, for perks, or simply waste. Voters might wish to eliminate the opportunity to extract rents by subjecting politicians to rules stipulating what they can and must do under given conditions. But the need to react to unforeseen developments and the complexity of the situation makes the writing of such contracts impossible. For the same reasons, politicians cannot realistically commit fully to promises made during election campaigns. Hence, like principal-agent relations in many other settings, the voter-politician relationship resembles an "incomplete contract" (Seabright, 1996; Persson *et al.*, 1997a, b; Tabellini, 2000).

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The second aspect is that most public spending today is targeted at subgroups of citizens (taxpayers) in society. Targeted public policies, when paid for from the general tax fund, involve redistribution of resources among citizens; hence we refer to them as distributive policies. The important implication of distributive policies is that those who benefit from a specific public policy and those who pay for it are generally not the same. Instead, those who benefit typically pay a small share of the total cost. As a result, politicians representing the interests of individual groups in society tend to overestimate the net social benefit from targeted public policies, as they perceive the full social benefit from policies targeting their constituencies, but only that part of the social cost that the latter bear through their taxes. This is the “common pool” property of public budgeting (von Hagen and Harden, 1996).

Both the principal-agent relationship and the common pool of property generate potential for excessive levels of spending, taxation, and public borrowing. The more rampant the principal-agent problem, the greater will be the divergence between voter preferences and the level and composition of public spending. Comparisons of jurisdictions in which public finances are determined by direct democracy with jurisdictions in which representative democracy prevails show that, *ceteris paribus*, direct democracy leads to lower levels of government expenditure and taxes, lower levels of government debt, an increase in local versus state spending, and a tendency to finance government expenditure by charges rather than broad-based taxes (Pommerehne, 1978; Matsusaka, 1995; Kirchgässner *et al.*, 1999; Feld and Kirchgässner, 1999).

Similarly, the more severe the common pool problem, the greater will be the divergence between the marginal social utility and the marginal social cost of targeted public policies. Empirical studies show that this leads to excessive levels of spending, deficits, and debt (von Hagen 1992; von Hagen and Harden, 1994a; Strauch, 1998; Kontopoulos and Perotti, 1999). Other empirical studies suggest that government spending and debt increase with the intensity of ideological and ethnic divisions within a society (Roubini and Sachs, 1989; Alesina and Perotti, 1995; Alesina *et al.* 1997), or by ethnolinguistic and religious fractionalisation (Annett, 2000). To the extent that such conflicts make voters on either side of the divide neglect the tax burden falling on those on the other side, they aggravate the common pool problem.

Societies can create institutions that mitigate these problems. Three institutional approaches are particularly relevant in this context.

- Imposing fiscal rules, i.e., ex ante controls such as balanced-budget constraints or referendum requirements for tax hikes that restrict the scope of choices elected politicians can make regarding public finances;

- Designing electoral rules promoting political accountability and competition and increasing the politicians' incentives to deliver the policies voters most prefer;
- Designing the decision-making processes over public finances that induce policy makers to recognise more fully the marginal social benefits and costs of their policies.

In this paper, we review and discuss recent research into these three approaches and their relative success in mitigating the principal agent and common pool problems. In Section II, we discuss fiscal rules as instruments to limit the principal agent problem and the common pool problem. In Section III, we consider the role of electoral institutions in shaping and limiting the principal agent problem. In Section IV, we look at the institutional aspects of decision-making processes regarding public finances. In Section V, we conclude with some remarks on institutional reform.

II FISCAL RULES

Most state governments in the US and provincial governments in Canada are subject to balanced budget requirements or debt ceilings, and many state constitutions in the US include numerical expenditure limits or require public referenda for raising tax rates. History suggests that these controls were often imposed by taxpayers, who were angry about the spending profligacy of their elected representatives (Eichengreen and von Hagen, 1996; Millar 1997). There is a fair amount of variation in the scope and strictness of these constraints, documented by ACIR (1987) and Strauch (1998). Von Hagen and Eichengreen (1996) and Stein *et al.* (1999) document fiscal rules imposed on sub-national governments in other countries. Subjecting policy makers to such *ex ante* controls seems the most straightforward approach to controlling their behavior and they seem attractive for simplicity and transparency.

But how successful are such constraints? Empirical evidence for US state governments suggests that they do limit the size of the annual deficit in the current budget and reduce the government debt ratio, if "full faith and credit" debt is considered (Strauch 1998; Eichengreen 1990). But if other types of debt instruments including the debt of off-budget entities are considered, numerical constraints have no effect on public debt ratios (von Hagen, 1991). This indicates that governments subject to stringent numerical deficit constraints tend to substitute debt instruments not covered by the legal rule for full faith and credit debt. Kiewiet and Szakalay (1996) find another substitution effect, namely that state governments subject to more restrictive

borrowing constraints tend to be associated with municipal governments incurring larger debts than elsewhere. Von Hagen and Eichengreen (1996) find that countries where sub-national governments are subject to more stringent statutory borrowing constraints tend to have higher central government debt ratios. This is a third substitution effect. Strauch (1998) shows that constitutional expenditure limits in the US induce a shift from the (constrained) current budget to the (unconstrained) investment budget, but they do not constrain total spending effectively.

The key insight then is that the effectiveness of fiscal rules is limited at best, because politicians are likely to find ways to circumvent them. This conclusion matters for Europe and its monetary union, because the fiscal framework of EMU relies heavily on the fiscal rules imposed on the member governments by the Maastricht Treaty and the Stability and Growth Pact. In fact, the success of the deficit and debt limits under EMU has been quite limited so far (Hughes-Hallett, Strauch and von Hagen, 2001). When these limits were first imposed in 1992, the average debt ratio of the European Union states stood at 60 per cent of GDP. In 1998, when euro-area membership was decided, it was over 75 per cent. This increase was driven mainly by the fiscal developments in Germany, France, Spain, Italy, and the UK. It is probably no coincidence that these are the largest countries among the 12 EMU states. In contrast, the debt ratios of the small states declined significantly during the post-1992 period, indicating that the fiscal constraints of EMU were more effective in these states. The experience suggests that the role of external political pressures, such as admonitions brought by the European Commission, are not strong enough to coerce internal politics in large countries. Thus, if they are effective at all, the *ex ante* controls of EMU may discipline fiscal policies in the small member states, but not in the larger ones. Recent experience confirms this conjecture. The German government was unwilling to accept a warning letter from the Commission, although such a letter was warranted given its fiscal performance in 2001. Similarly, the French and the Italian governments announced their intention to ignore earlier commitments to balancing the budget by 2004 made in their Stability Programmes. There are also increasing complaints about creative accounting to circumvent the fiscal rules of EMU.

III POLITICAL COMPETITION AND ACCOUNTABILITY

Procedures for holding policy makers responsible for their actions are a key element of the incomplete contract between voters and their elected representatives (Persson *et al.* 1997a, b). The election process is the most

important one. Electoral institutions in particular allow voters to hold policy makers personally accountable for past policies and create competition among politicians.

It is plausible to assume that politicians are opportunistic in the sense that they care about their rents and wish to remain in office. If so, elections give voters the opportunity to hold them accountable for past performance. This is the main tenet of the retrospective-voting paradigm. Voters reappoint incumbents, if, based on the information available to them, they find their behaviour satisfactory. Otherwise, they vote for alternative contestants competing for the same office. Rents will be the more limited, the stronger is accountability and the fiercer is competition.

Electoral rules can be compared according to district magnitude, i.e., the number of representatives in parliament elected from each electoral district. At one extreme, exactly one representative is chosen from each district, i.e., the candidate with the largest number of votes in a district wins the seat in parliament. This is the plurality rule. At the other extreme, an entire country is just one large electoral district and candidates for all seats in parliament are drawn from national party lists according to the share of votes cast for that list in the entire country. This is the rule of proportional representation, which prevails, e.g., in the Netherlands. Less extreme forms of proportional representation divide a country into several large electoral districts, with party lists presented for each of them.

Plurality rule focuses the election on the personal performance of the individual candidates, thus maximising personal accountability. Proportional representation, in contrast, weakens personal accountability, as voters can assess only the average performance of all candidates elected from the party list. However, plurality rule also gives voters the opportunity to reward politicians for channelling general tax funds to the specific region where they live. Under proportional representation, a similar opportunity to reward politicians for channelling general tax funds to specific groups in society exists only if political parties are organised social, ethnic, or other clear-cut cleavages in society. In contrast, proportional representation reduces the politician's incentives for using distributive policies to secure his reelection if parties encompass many social groups.

This reasoning has three public finance implications.

- As personal accountability puts a check on the politician's ability to extract rents, we should expect less waste and smaller levels of public spending under plurality rule than under proportional representation.
- As specific groups of voters reward politicians for distributive policies in their own favour, plurality rule and proportional representation with many small parties lead to a higher share of distributive policies rule than

proportional representation with few and more encompassing parties (Tabellini, 2000). Thresholds requiring a minimum percentage of voters to obtain any seats in parliament are important instruments to reduce the number of parties and make them more encompassing.

- Representatives from different districts or of different social groups are likely to engage in logrolling and games of reciprocity to find majorities for policies favouring their constituencies. Thus, plurality rule and proportional representation with many small parties contribute positively to the common pool problem. From this perspective, we should expect larger levels of spending and larger deficits and debts in countries with plurality rule or proportional representation with many small parties than in countries with proportional representation and few, encompassing parties.

This leads us to the other aspect, competition. The need to gain a large share of votes in a district under plurality rule is an important barrier to entry for small parties. Political newcomers find it difficult to challenge incumbent politicians, because they need a majority to succeed from the start. In contrast, newcomers can win at least a small number of seats in parliament under proportional representation. Political competition is, therefore, more intense under the latter system, particularly when minimum vote thresholds are low. If contestants use the election campaign to identify waste and point to instances of rent-extraction, one can expect more intense competition to lead to less waste and smaller rents. Thus, the consequences of weaker accountability under proportional representation may be compensated by more intense competition.

Empirical Evidence

Empirical research in this area has only recently begun. It is difficult, as electoral rules often do not neatly conform to the stylised characterisations used above. For example, in some countries with proportional representation, voters can influence the rank individual politicians have on the party list. This strengthens personal accountability under this electoral system. Japan's pre-1994 system of proportional representation allocated multiple seats to each district, which created a huge incentive for distributive policies as a seat could be won with as little as 14.2 per cent of the votes. More detailed characterisations are necessary to capture the full details of electoral rules.

Some interesting evidence exists nevertheless. Persson and Tabellini (1999b) find that countries with plurality rule have smaller governments, although this result is not statistically robust. Persson, Tabellini, and Trebbi (2000) find that proportional representation is associated with higher levels of corruption than plurality rule. If corruption is a proxy for rents, this confirms the theory. Persson and Tabellini (1999b) also show that plurality rule

elections and presidential government lead to lower levels of general public goods than proportional representation and parliamentary government.

Hallerberg (2000) studies the public finance impact of Italy's electoral reforms. In 1994, Italy replaced its system of proportional representation by one that has three-quarters of all seats in parliament elected by plurality rule and the remaining seats on the basis of proportional representation. The reform was introduced with the hope that plurality rule would generate more stable governments and a bi-polar party system. As it were, this did not happen immediately. But when elections were called again in 1996, the tendency towards a bi-polar system became stronger. Hallerberg argues that this was an important step preparing Italy's accession to EMU.

Thus, the existing evidence, scant as it is, supports the view that electoral rules have important consequences for public spending. The policy implication is that rules strengthening accountability and competition are effective controls of rents and distributive policies.

IV LIMITING THE COMMON POOL PROBLEM: THE BUDGET PROCESS

Public budgeting involves an externality – money from a general tax fund is used to finance distributive policies. At the heart of the problem is a misperception about the true budget constraint and true shadow relative prices of public policy programmes. Individual politicians assume that an increase in spending on targeted policies will provide their constituencies with more of the public services they desire at only a fraction of the total cost, since the rest is paid by other taxpayers. The less weight they give to the tax burden of people outside their constituencies in their decisions, the greater the tendency to ask for more public services than they would, if each benefiting group were charged the full cost of the services delivered to it. The larger the number of politicians drawing on the same general tax fund, the lower seems marginal cost of distributive policies for each of them and the greater is the overspending bias. Putting this argument into a dynamic context, where money can be borrowed to finance current spending, one can show that the common pool problem leads to excessive deficits and government debts in addition to excessive spending levels (Velasco 1999; von Hagen and Harden, 1996).

The analogy with a common pool problem suggests that the excess spending and deficit biases can be reduced by making politicians more aware of the true budget constraint. This is the main role of the budget process in our context. The budget process consists of the formal and informal rules governing

budgetary decisions within the executive and the legislative branches of government. It includes the rules relating to the formulation of a budget by the executive, to its passage through the legislature, and to its implementation by the executive. The budget process distributes strategic influence and creates or destroys opportunities for collusion. Appropriately designed, it can induce policy makers to take a comprehensive view of the costs and benefits of all public policies financed through the budget. Inappropriate design fails to do that and encourages politicians to care only about the rents and distributive policies they can attract for themselves. Where that is the case, we call a budget process fragmented. The opposite of fragmentation is centralisation of the budget process.

The budget process can serve its purpose effectively only if all conflicts between competing claims on public finances are indeed resolved within its scope. Four deviations from this principle undermine its functioning.

- The use of off-budget funds, which allow policy makers to circumvent the constraints of the budget process and remove decisions altogether from being challenged by conflicting distributional interests.
- “Non-decisions,” which occur when expenditures included in the budget are determined by developments exogenous to the budget process. Prime examples are the indexation of spending programmes and “open-ended” spending appropriations, e.g., welfare payments based on entitlements whose parameters are fixed by simple law.¹ They allow policy makers to avoid “tough” decisions (Weaver, 1986), but they degrade the budget process to a mere forecast of exogenous developments.
- “Mandatory spending laws”, i.e., non-financial laws that make certain government expenditures compulsory and the budget a mere summary of spending mandates created by simple legislation. An effective budget process requires a clear distinction between non-financial laws (which create the authorisation for certain government undertakings) and the budget, which makes specific funds available for a specific time period.
- Contingent liabilities such as guarantees for liabilities of public or non-public entities. While one must recognise that contingent liabilities cannot be fully avoided and that a proper accounting of them is a difficult task, their existence and importance for the government’s financial stance can be brought to the attention of decision makers in the budget process by requiring the government to submit a report on the financial guarantees it has entered into as part of the budget documentation.

¹ Setting the relevant parameters of entitlement programmes is part of the annual budget process in several countries. Another approach, used in Denmark, is to set cash limits on welfare appropriations and require the relevant minister to propose spending adjustments and changes in the relevant non-financial laws if these limits are overrun (von Hagen and Harden 1994a).

Institutional Elements of Centralisation

Budget processes can be approximately divided into four stages, each involving different actors with different roles. The “executive planning stage” usually begins about a year before the relevant fiscal year and ends with the submission of a draft budget to the legislature. It involves the setting of budget guidelines, bids for budget appropriations from the various spending departments, the resolution of conflicts between the spending interests in the executive, and the drafting of the revenue budget. The “legislative approval stage” includes the process of parliamentary amendments to the budget proposal, which may involve more than one house of parliament. This stage ends with the passing of the budget law. The “executive implementation stage” covers the fiscal year to which the budget law applies. During this stage, deviations from the budget law can occur, either formally by adoption of supplementary budget laws in parliament, or informally by shifting funds between chapters of the budget law and by overrunning the spending limits provided by the law. The “*ex post* accountability stage” involves a review of the final budget documents by a court of auditors or a similar institution checking the consistency of the actual spending and revenues with the legal authorisation.

Institutional elements of centralisation primarily concern the first three stages, with different elements applying to different stages.² At the executive planning stage, the purpose is to promote agreement on spending and deficit targets derived from a comprehensive view of the budget. Maximum fragmentation prevails, when the budget is degraded to a mere collection of uncoordinated bids from the individual spending agencies. Elements of centralisation promote the consistent setting of targets at the outset of the process and assure that they constrain subsequent decisions effectively. A key issue is the process of conflict resolution among the members of the executive. Uncoordinated and *ad hoc* conflict resolution involving many actors simultaneously promotes log-rolling and reciprocity and, hence, fragmentation. Cabinet decision-making based on the principle of unanimity, as in Japan, has a similar effect. Fragmentation can be limited by the introduction of senior cabinet committees with the authority to decide in cases of budgetary conflicts. At the legislative approval stage, elements of centralisation control the debate and voting procedures in parliament. Because of the much larger number of decision makers involved, the common pool problem is even larger in the legislature than in the executive. Fragmentation is rampant, when parliament

² At the last stage of the process, the legality of the budget is checked by the appropriate accounting body. Obviously, the design of the budget process becomes ineffective, if policy makers operate outside the law. Thus, the last stage provides an important, necessary condition for the effectiveness of institutional design.

can make unlimited amendments to the executive's budget proposal, when spending decisions are made in legislative committees with narrow and dispersed authorities ("Balkanisation of Committees," see Crain and Miller, 1990), and when there is little guidance of the parliamentary process either by the executive or by the speaker. Elements of centralisation protect the executive's or, in presidential systems, the budget committee's position as an agenda setter in the legislature.

At the implementation stage, elements of centralisation assure that the budget law effectively constrains the spending decisions of the executive. The weaker the constraints the budget law creates for actual spending decisions during the year, the more fragmented is the budget process. The finance minister's ability to monitor and control spending flows during the fiscal year is critical at this stage. Another important element is the rule concerning changes of the budget law during the year. The easier it is to change the budget law or to replace it by a new one, the less effective is the budget process in constraining financial decisions of the government and solving the common pool problem. The frequent use of supplementary budgets during the fiscal year is a strong indicator of fragmentation at this stage.

Transparency of the budget and the budget process is an important design element on all three stages. Lack of transparency creates opportunities for collusion among policy makers pursuing their own interests. It prevents decision makers in the budget process from developing a comprehensive view of the full spending and revenue consequences of their decisions. Transparency requires that the budget documents are comprehensive and that expenditures are clearly attributed to the relevant spending making units within the government. It is promoted by clear accounting rules including for tax expenditures and contingent liabilities such as guarantees. While it is sometimes argued that intransparency strengthens the role of the finance minister as a guardian of fiscal discipline (e.g. Milesi-Ferretti, 2000), lack of transparency of the budget and the budget process prevails more regularly in practice, when the finance minister is weak and the process very fragmented. While the lack of transparency may be useful for a ministry in such circumstances, this is clearly not a desirable design.³

Reviewing elements of centralisation in Europe, the US, Latin America and Asia reveals that centralisation follows two basic approaches. The first is centralisation based on "delegation" or vesting individual actors with special strategic powers. The second is centralisation based on "contracts" or binding agreements among all participants negotiated at the outset of the budget process.

³ A prime example of this is the budget process in Japan, see Ichi (2000).

Delegation

With delegation, the budget process lends special authority to a “fiscal entrepreneur” with the authority to set the broad parameters of the budget and to assure that all other participants observe them. An effective “entrepreneur” has the ability to monitor the other participants and to use selective punishments against any defectors. Among the cabinet members, the “entrepreneur” is typically the finance minister. Since the finance minister is not bound by individual spending interests as much as the spending ministers, and since the finance minister typically is charged with drafting the revenue budget, it is plausible to assume that the finance minister takes the most comprehensive view of the budget among the members of the executive.

In practice, delegation can take a variety of forms. In the French model, the finance minister, backed by the prime minister, has strong agenda-setting powers over the other cabinet members. The British budget process evolves as a series of bilateral negotiations between the spending departments and the finance minister, in which the latter has strong bargaining power based on superior information, seniority, and political back-up from the prime minister. The German model of delegation gives the finance minister veto power for all budgetary decisions in cabinet meetings.

Under the delegation approach, setting budget targets and drafting the budget proposal is mainly the responsibility of the finance ministry, which monitors the individual bids, negotiates directly with the spending departments and approves the bids submitted to the final cabinet meeting. Unresolved conflicts between individual spending and the finance ministers are typically arbitrated by the prime minister.

At the legislative stage, the delegation approach lends large agenda-setting powers to the executive over parliament. One important instrument here is to limit the scope of amendments parliamentarians can make to the executive’s budget proposal. In France, for example, amendments cannot be received unless they reduce expenditures or create a new source of public revenues. A second element concerns the voting procedure. The French government, for example, can force the legislature to vote on large parts of or the entire budget in a *block vote*, with only those amendments considered that the executive is willing to accept. In the UK, the executive can make the vote on the budget a vote of confidence, thus raising the stakes for a rejection considerably. The position of the executive can also be strengthened by giving the finance minister veto power over the budget passed by the legislature, as in Germany and Spain.

A final element concerns the budgetary authority of the upper house. Where both houses have equal budgetary authority, as in Italy or Belgium, finding a compromise between the two houses is a necessary part of the budget process.

This tends to weaken the position of the executive as it now faces two opponent bodies. To strengthen the executive, the budgetary authority of the upper house may be limited as in France and Germany, where the lower house prevails if an agreement between the two chambers cannot be reached. In the UK, the upper house has no budgetary authority at all, leaving the executive with only one chamber to deal with in the budget process.

At the implementation stage, finally, centralisation requires that the finance minister be able to monitor and control the flow of expenditures during the year. This may take the form of requiring that the spending departments obtain the finance minister's authorisation to disburse funds during the year. The finance minister's authority to impose cash limits during the year is another control mechanism. Effective monitoring and control is also important to prevent spending departments from behaving strategically, i.e., from spending their appropriations early in the year and demanding additional funds later with the threat of closing down important public services otherwise.

Furthermore, centralisation requires tight limits on any changes in the original budget law through the modification of appropriations once the fiscal year has begun. One element here is the requirement that transfers of funds between different chapters of the budget be authorised by the finance minister or parliament. The same applies to transfers of funds between different fiscal years. Although carry-over provisions have obvious efficiency gains, their use should be limited and strictly monitored to assure that the finance minister can keep track of a spending department's financial position. Another point is to restrict the use of supplementary budgets. Where supplementary budgets during the fiscal year become the norm, as in Italy and Belgium in the 1980s and Germany in the 1990s, one cannot expect that policy makers will take the constraints embedded in the original budget law seriously.

Contracts

Under the contract approach, the budget process starts with an agreement on a set of binding fiscal targets negotiated among the members of the executive. Emphasis here is on the bargaining process as a mechanism to reveal the externalities involved in budget decisions and on the binding nature of the targets. A prime example for this approach is the Danish budget process, which, since 1982, starts with negotiations among the cabinet members fixing spending limits for each spending department. Often, these spending limits are derived from medium-term fiscal programmes or the coalition agreement among the ruling parties. Irish coalition agreements since 1989 included medium-term fiscal strategies to reduce the public debt, which provided the background to the annual negotiations over budget targets.

The finance ministry's role under this approach is to evaluate the consistency of the individual departments' spending plans within these limits. As in the Netherlands, for example, the finance minister usually has an information advantage over the spending ministers in the budget negotiations, but no extra strategic powers. Conflict resolution involves senior cabinet committees and often the leaders of the coalition parties in the legislature.

At the legislative stage, the contract approach places less weight on the executive's role as an agenda setter and more weight on the role of the legislature monitoring the faithful implementation of the fiscal targets. Institutionally, this means that the contract approach relies less on controlling parliamentary amendments and more on the legislature's ability to monitor the fiscal performance of the executive. One important element of this is the legislature's right to request information from the executive. It can be improved by setting up committees whose authorities reflect the authorities of the spending departments, and by giving committees a formal right to request information from the executive and to call witnesses from the executive to testify before committees. The Danish parliament, for example, has all three of these rights, while the German parliament has only the first and the British parliament has neither one.

At the implementation stage, the contract approach resembles the delegation approach in emphasising the monitoring and control powers of the finance minister.

Institutional Choice

The delegation approach relies on hierarchical structures within the executive, and between the executive and the legislature. In contrast, the contract approach builds on a more even distribution of authorities in government. In democratic settings, hierarchical structures typically prevail within political parties, while relations between parties are more even. This suggests that the institutional choice between the two approaches depends critically on the number of parties in government. More specifically, Hallerberg and von Hagen (1998) suggest that delegation is appropriate for single-party governments, while the contracts approach is appropriate for multi-party coalition governments. There are two reasons behind this conjecture.

First, a spending minister in a one-party government can be reasonably sure that the finance minister shares his basic spending preferences; disagreement with the finance minister will be mainly as a result of the common pool problem. In a coalition government, in contrast, cabinet members are likely to have more diverging views regarding spending

priorities. If this is true, the delegation of strategic powers to the finance minister, who necessarily comes from one of the coalition parties, would create a principal agent problem for a coalition government, that does not arise in a single-party government. That is, a strong finance minister might abuse his powers and unduly promote the political interests of his own party at the cost of others. This problem does not arise under the contract approach, as the fiscal targets are negotiated among all cabinet members.

Second, delegation and contracts use different enforcement mechanisms. In one-party governments, the ultimate punishment for a defecting spending minister is his dismissal from office. Such punishment is heavy for the individual, but generally light for the government as a whole. It can be used, if the prime minister is sufficiently strong and has the authority to select and replace cabinet members.⁴ In coalition governments, in contrast, individual defecting ministers cannot be punished easily. Since the distribution of portfolios is typically given by the coalition agreement, the prime minister cannot easily dismiss intransigent ministers from parties other than his own.

Breaking up the coalition is the ultimate punishment in coalition governments. This punishment is heavy for the entire coalition. The point is illustrated by the fact that fiscal targets are often part of the coalition agreement. The credibility of this enforcement mechanism hinges on two conditions. One is the existence of alternative coalition partners in parliament. The other is the expected response of the voters, as a coalition may be broken up with the anticipation of new elections.

These different enforcement mechanisms also explain the different relations between the executive and the legislature in the legislative phase of the budget process. When a single ruling party enjoys a majority in parliament, the main concern of the legislative stage is to limit the scope of defections from the budget proposals by individual members of parliament. With multi-party coalitions, in contrast, defections from the budget targets, especially if they are backed up by the coalition agreement, are a weaker concern. However, each party involved in the coalition will want to watch carefully that the executive sticks to the coalition agreement. The delegation approach, therefore, typically makes the executive a much stronger agenda setter in parliament than the contract approach, while the contract approach lends more monitoring powers to the legislature than the former.

Finally, commitment to fiscal targets is *per se* much less credible for one-party governments. Consider a single-party government with a weak prime minister and a weak finance minister that has announced a set of fiscal

⁴ The Japanese example shows that this is not necessarily the case even in one-party settings.

targets at the outset of the budget process and assume that some spending ministers renege on the targets later on. Other cabinet members cannot credibly threaten the defectors with dissolving the government, since they would punish themselves. A credible threat is absent, the entire cabinet will just walk away from the targets.⁵

The number of parties in government strongly depends on electoral institutions. Intuitively, the chance that one party wins a majority in parliament is the larger, the fewer parties there are. In two-party systems, the emergence of an absolute majority is a virtual certainty. Empirical studies show that plurality rule promotes the emergence of two-party systems and one-party majority governments (Duverger 1954; Taagepera and Shugart, 1989, 1993). In contrast, proportional representation allows for more variation in district magnitude, but is consistently characterised by multi-party coalition governments (Lijphart, 1984, 1994; Taagepera and Shugart, 1989, 1993), especially if minimum-vote thresholds are low. These patterns suggest that countries seeking to centralise their budgetary processes are more likely to opt for the contract approach, if their elections are based on proportional representation (and low thresholds), while they are more likely to opt for delegation, if their elections are based on plurality rule. Hallerberg and von Hagen (1998) and Hallerberg *et al.* (2001) test and confirm this hypothesis for the European Union states.

This has important implications for the fiscal framework of EMU. The Excessive Deficit Procedure and the Stability and Growth Pact strongly resemble the contract approach to centralising budget processes. If so, one should expect that these procedures are more effective in countries whose institutional environment is favorable for this approach, and less effective in environments where the delegation approach is appropriate. Empirical evidence provided by Hughes-Hallett *et al.* (2001) confirms exactly that. Between 1992 and 1996, debt ratios increased significantly in the European states with fragmented processes and those relying on delegation, but very little in states applying a contract approach. After 1996, states applying a contract approach achieved much larger reductions in their debt ratios than the others. Hallerberg *et al.* (2001) show that many states applying a contract approach implemented new mechanisms at the national level strengthening

⁵ This conclusion is qualified by the observation, made above, that the effectiveness of the contract approach depends on the availability of alternative coalition partners. German governments of the past 30 years were coalitions between a large and a small party with no alternative partner available for either one. Germany's budget process, which was built on delegation, therefore fits this environment. When the German government was formed by the two large parties CDU and SPD in the late 1960s, elements of a contract approach were introduced to secure a high degree of fiscal discipline.

their ability to reach their fiscal targets despite unexpected economic developments. States relying on delegation did nothing or little to achieve that. This suggests that the Stability Programmes and the Stability and Growth Pact will work more effectively in states where the domestic budget process is characterised by a significant degree of centralisation under the contract approach. They will be much less effective in assuring fiscal discipline in states, where centralisation of the budget process relies on delegation, and in states with rather fragmented budget processes.⁶

Empirical Evidence

A fast-growing literature starting with von Hagen (1992) has presented empirical evidence supporting the hypothesis that centralisation of the budget process leads to smaller government deficits and debts. Von Hagen (1992) provided evidence from 12 European Union countries showing a significant negative association between the centralisation of the budget process and general government deficits and debts relative to GDP. Von Hagen and Harden (1994b) extend and broaden the analysis and confirm the hypothesis that centralisation of the budget process is associated with smaller deficits and debts. De Haan and Sturm (1994) again work with European Union data and show that the hypothesis holds up empirically even when a number of political factors such as the composition and stability of governments is controlled for. Hallerberg and von Hagen (1998, 1999) use panel data analysis for 15 EU countries and show that centralisation of the budget process goes along with smaller annual budget deficits even when controlling for a number of economic determinants of the budget deficit and other political variables.

Gleich (2002) presents a study of the budget processes in ten Central and East European countries, all candidates for accession to the EU. He documents a considerable degree of variation in the design of these processes across the ten countries. This is interesting, since a budget process in the proper sense did not exist under the former, socialist regime. All ten countries hold elections under various forms of proportional representation. Gleich shows that centralisation conforms to the contract approach in these countries and that there is a strong negative association between the degree of centralisation of the budget process and the public sector deficits and debts that emerged in the second half of the 1990s.

Turning to geographical areas outside Europe, Alesina *et al.* (1995) and Stein *et al.* (1999) use panel data analysis from Latin American countries to show that centralisation of the budget process goes along with lower govern-

⁶ This proposition is confirmed by the fact that neither France nor Germany bothered much to announce their plans for tax reforms in the context of their stability programmes in 2000.

ment deficits. Jones *et al.* (1999) analyse a panel of Argentine provinces and confirm the same hypothesis. Lao-Araya (1997) provides similar results for eleven Asian countries. Strauch (1998) uses data from the 50 US state governments to show that centralisation significantly reduces annual budget deficits. Taking a different methodological approach, the country studies of Stienlet (2000), Molander (2000) and Strauch and von Hagen (1999) point to the importance of centralisation in achieving (or, in the case of Germany losing) fiscal discipline.

Finally, Strauch (1998) and Gleich (2002) show that centralisation of the budget process is also associated with smaller levels of government spending, as the common pool argument suggests.

To summarise, the hypothesis that centralisation of the budget process leads to lower government deficits and debts can be considered as empirically well established today. It has been confirmed in very different geographical and political settings. Thus, one can conclude that centralisation of the budget process is an important and effective way to mitigate the common pool problem of public budgeting.

Centralisation and Flexibility of Budgetary Policies

Because centralisation emphasises strict adherence to fiscal targets, one might suspect that it implies rigidity of budgetary policies and reduces the scope for reaction to unforeseen events. If so, there could be a trade-off between achieving a higher degree of fiscal discipline and achieving a desirable degree of macroeconomic stabilisation.

However, flexibility to react to unforeseen events can be achieved at the implementation stage of the budget process in a number of different ways without working against centralisation, such as the possibility to charge expenditures against future budgets or to transfer unused appropriations to the next year or the creation of a “rainy day fund,” i.e., an unspecified appropriation that can be used for emergencies. Hallerberg *et al.* (2001) show that many of the EU states that have adopted a contract approach to centralisation implemented rules enabling them to deal more effectively with unexpected revenue or spending developments in recent years.

Hallerberg and von Hagen (1999) estimate the cyclical elasticity of government deficits in the 15 European Union states. Based on panel data, they find that centralisation *per se* does not change the cyclical elasticity. In fact, countries with strong finance ministers are characterised by a relatively larger cyclical elasticity. This suggests that a strong finance minister can react more quickly to economic downturns and upswings. Importantly, there is no indication of a trade-off between macroeconomic stabilisation and mitigating excessive spending in the design of a budget process.

V INSTITUTIONAL REFORM

Fiscal institutions have important consequences for the spending performance of governments, both in terms of the level of spending, the composition of spending, and the levels of deficits and debts. This suggests that appropriate institutional design can help mitigate problems of waste, divergences between public preferences and what the public sector delivers, and fiscal profligacy.

This claim rests on the basic conjecture that institutions frame the decisions made within them, i.e., that a given group of individuals facing a given problem makes predictably different decisions under different institutional arrangements. The obvious objection is, that policy makers would rid themselves of the institutions and ignore or change the rules if they feel constrained by them. After all, institutions are man-made and subject to change. Without a satisfactory answer to this objection, the power of institutions and the promises of institutional reform must remain in doubt.

Such an answer has three points. First, the individuals involved in decisions over public finances do not always have the authority themselves to change the rules. Second, even if policy makers feel constrained by existing institutions, they will want to change these institutions, only if they can be reasonably sure to achieve more desirable outcomes under the alternative. But this is far from trivial. Complex decisions made by groups are prone to instability and irrationality. Therefore, the absence of institutional rules is often much less desirable than the presence of rules, even if their constraints are being felt. Third, institutional rules in the budget context give individual policy makers assurance that excessive budget demands by others will not be successful, and thus make it easier for them to restrain their own demands.

Nevertheless, one should not interpret the theory and evidence outlined above as saying that a change in the letter of the law is an effective means to reduce rents, excessive spending, and deficits. Precisely because changing institutions takes some extraordinary effort, policy makers are unlikely to do that unless they are aware of an acute fiscal problem. But if that is the case, how can we prove that the institutional change contributed to the fiscal correction, if the latter was what policy makers wanted anyway?

A first point is that institutional changes are very visible to the public and the markets and, therefore provide an important signalling function. Governments showing the resolve for a more disciplined fiscal policy by reforming pertinent institutions will find it easier to convince the public and financial markets of their good intentions. To the extent that this reduces opposition against fiscal reforms and cutbacks, the necessary policy changes are made easier.

A second point is that the awareness of a fiscal problem may not be permanent. As other problems arise and the deficit returns to normal levels, the attention to the problems of waste, excessive spending and deficits is reduced and the tendency for overspending and excessive deficits rises again. At that point, having better institutions in place than before can be an important mechanism to preserve the collective memory of the previous difficulties.

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