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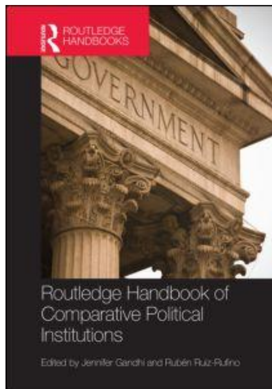

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FISCAL INSTITUTIONS

Joachim Wehner

The last two decades have seen a substantial growth in the comparative literature on the design of fiscal (or budget) institutions and their effects. Fiscal institutions are the rules and procedures that govern the budgetary process. The budgetary process covers the development of a draft budget by the executive, legislative review and approval, the execution of the budget during the fiscal year, and the production of annual accounts and their audit. For instance, the rules of the budgetary process determine whether the finance minister, prime minister, or president can impose ceilings on spending bids by individual line ministers, while amendment powers in relation to tax and spending bills determine the scope for legislators to influence budgetary choices. Such rules and procedures are often codified in law, but they can also be deeply entrenched conventions.

Largely based on theories of pork-barrel politics and common pool resources, empirical work has expanded steadily to cover different and diverse sets of countries. This work highlights that budget institutions can play an important role in the governance of public finances, and that they can help to explain variation in fiscal policy across countries and over time. As a result, the comparative study of budget institutions is not only of interest to academics, but also for policymakers in national governments and international organizations that seek to promote prudent management of financial resources.

This chapter provides an overview of the cross-national literature on the design of budget institutions. Section one looks at the theoretical foundation of most of this literature, which examines the common pool resource problem in budgeting and develops implications for the design of the budgetary process. The second section summarizes existing empirical work with cross-national data. Section three focuses on the complexity of institutional design. It highlights the potential for side effects and unintended consequences of budget institutions, and how they interact with other political variables to determine policy outcomes. The conclusion notes under-researched areas that should receive attention in further research.

The common pool resource problem

Most comparative work investigating the effect of budget institutions on fiscal policy draws on the basic idea that spending will be higher when decision-makers do not internalize the full costs of their actions. Weingast *et al.* (1981) expressed this as the "Law of 1/n" (see also Shepsle and

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Weingast 1981). In their model, expenditures can be targeted at a particular geographical district where they produce benefits, while costs are shared equally across all districts. The larger the number of districts, the smaller the share of the tax burden considered in spending decisions. Hence, assuming universalistic logrolls, "the degree of inefficiency in project scale… is an increasing function of the number of districts" (Weingast *et al*. 1981: 654). In other words, the possibility to disperse costs and to target benefits engenders a pro-spending bias as the number of decision-makers increases.

A number of studies support the prediction. Fiorino and Ricciuti (2007) and Bradbury and Crain (2001) find some evidence of the predicted effect of legislature size on expenditures, although in the latter case bicameralism is found to dampen the effect. Focusing on the executive arena, Perotti and Kontopoulos (2002) find that cabinet size is a determinant of fiscal outcomes in a panel of 19 OECD countries over the 1970 to 1995 period. Volkerink and De Haan (2001) show that deficits increase with the number of spending ministers, i.e. the total number of government ministers minus the minister of finance and/or the budget as well as the prime minister. The most comprehensive cross-national study so far, based on a global sample of 58 countries over a 24-year period, also reports a strong positive association between the number of spending ministers and central government budget deficits and expenditures (Wehner 2010a). A subnational study by Schaltegger and Feld (2009) on the fiscal consequences of cabinet size in Swiss cantons comes to similar conclusions.

Where party discipline is strong, the relevant fiscal decision-makers might be political parties instead of individual politicians in the legislature or the executive (Hallerberg 1999, 2004: 22–27). Bawn and Rosenbluth (2006) show a positive association between the number of governing parties and the size of government in 17 European countries between 1970 and 1998. The degree of party cohesion is related to the design of the electoral system (Carey and Shugart 1995). In a closed list proportional representation system with one nationwide constituency, party leaders may exercise very substantial control over the inclusion and placement of particular candidates on their party's list, which can be used to induce loyal behavior. On the other hand, where candidate selection is heavily decentralized to local constituencies, and candidates from the same party compete against one another for local support, party cohesion can be tenuous. Edwards and Thames (2007) and Hallerberg and Marier (2004) explore the fiscal consequences of electoral systems that engender such a "personal vote." The idea of the "Law of 1/n" can be adapted to such different contexts. Whether the relevant actors are parties, legislators, or ministers, the basic insight is that a failure to internalize the full cost of their actions induces a pro-spending bias (see also Velasco 2000).

Yet, not all decision-makers have the same incentives. Alesina and Perotti (1996: 20–21) explain:

> The constituencies of spending ministers are groups and industries who benefit from certain spending programs while, at least in theory, the constituency of the Treasury Minister is the "average" tax-payer. Thus the spending ministers do not internalize the aggregate costs of certain spending programs, while the Treasury has an incentive to internalize.

Hence, one possible response to the "common pool resource" problem could be to strengthen the role of decision-makers who are more likely to consider overall costs than spending ministers (Poterba and von Hagen 1999; Strauch and von Hagen 1999).

Von Hagen and Harden (1995: 772–775) present a much-cited model that centers on this very idea, and yields concrete recommendations for the design of the budgetary process. They model decision-making in a government consisting of several spending ministers, each of whom

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gets funds that are used to produce activities in order to achieve a policy target. While each has an interest in achieving his or her policy target and minimizing the excess burden from taxation, each also receives a private utility gain from her budget allocation. Moreover, each spending minister only considers her constituency's share of the total excess burden—as posited by the "Law of 1/n." Indeed, if the process follows a bottom-up approach that allows each spending minister to separately draft a budget for his or her department, so that the total budget consists simply of the sum of all bids submitted by the spending ministers, the aggregate outcome resulting from this bottom-up process is larger than optimal for the government as a whole.

Von Hagen and Harden (1995) go on to show that when a minister without portfolio, who has an incentive to consider the overall impact of excess taxation, is given strategic power vis-à-vis his or her colleagues in spending ministries, the resulting amount of total spending is closer to the joint optimum than under the bottom-up process: the centralization of the budgetary process in the hands of an actor with incentives to internalize costs mitigates the common pool resource problem. A second solution they identify is for decision-makers to commit to binding fiscal targets, and they hint that the choice of approach is linked to the partisan composition of governments.

Hallerberg (2004) and Hallerberg *et al.* (2009) expand the latter idea and argue that the party system and the majority-minority dichotomy determine the fiscal framework. In two-party systems, governments with little internal discord delegate to a strong finance minister. This accounts for the dominant role of the Treasury in the United Kingdom under single party government. However, in more ideologically fragmented multi-party governments, coalition partners may be unwilling to delegate to a single individual from one of the governing parties, and instead prefer commitment to binding targets through a fiscal contract or coalition agreement. Practices adopted in countries such as the Netherlands or Finland illustrate the second approach. In addition, a "mixed" approach is possible with minority governments, involving delegation during the executive stage and a fiscal contract with supportive parties in the legislature. Finally, with low levels of political competition, degeneration to fiscal fiefdoms is likely, where institutional controls on the common pool resource problem are lacking.

Empirical evidence on the fiscal impact of budget institutions

Early empirical work on the effects of budget institutions focused on the American states. Examples include a study by von Hagen (1991) that casts doubt on the effectiveness of formal budget rules, an issue to which I return in the following section. Crain and Muris (1995) investigate how legislative committee structures affect fiscal policy outcomes, and work on fiscal adjustment has examined the role of budget institutions (Alt and Lowry 1994; Poterba 1994). Due to the relatively good availability of fiscal and institutional data, as well as the variation in practices and outcomes across a larger sample of comparable units, the American states provide a particularly good laboratory for such questions.

For a number of years, a major impediment to cross-national work on the fiscal consequences of budget institutions was the scarcity of comparative data, but this situation is changing (Hallerberg 2013). The most consistent data gathering effort is the fiscal governance database compiled for 15 European Union countries and covering the years 1985 to 2004 (Hallerberg *et al.* Strauch, and von Hagen 2009). The dataset contains detailed information on the use of fiscal targets and contracts, as well as the procedural arrangements that govern the formulation and execution of budgets, consistent with the authors' theoretical work.

Some other researchers have compiled time series data on the evolution of budget institutions. One example is work by Filc and Scartascini (2007) that builds on budget institutions data

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collected for Latin American countries in the mid-1990s (Alesina *et al.* 1999). Other efforts include the Budget Practices and Procedures Database of the OECD, which in 2007 was extended to a large number of developing and transition countries. Several datasets have been compiled to assess fiscal transparency (for a review, see Wehner and de Renzio 2013). An impressively rigorous effort is the Open Budget Index initiative, which systematically tracks the evolution of budget transparency practices across almost 100 countries on a regular basis, going back to 2006 (International Budget Project 2006). The questionnaire also covers procedural aspects such as the role of the legislature and audit institutions in the budgetary process. Hence, the availability of data on fiscal institutions has been improving steadily.

Cross-national empirical work on the fiscal effects of budget institutions initially had a strong geographical focus on Western Europe. This work was driven by concerns in the run-up to the creation of the monetary union about the ability of different countries to achieve and maintain the required convergence in fiscal policy. Using data for European countries in the 1980s, von Hagen (1992) finds that certain institutions safeguard fiscal discipline, namely a strong position of the finance minister or prime minister in negotiations within the executive, a parliament with limited powers to amend the budget, and limited flexibility and strong finance ministry control during the implementation of approved budgets (see also Hallerberg 2004; Hallerberg *et al.* 2007, and Hallerberg *et al.* 2009). More recent work has expanded this research to Central and Eastern Europe, also finding evidence in support of the fiscal institutionalist argument (Gleich 2003; Yläoutinen 2004; Fabrizio and Mody 2006; Hallerberg and Yläoutinen 2010).

In one of the first cross-national studies on countries outside Europe, Alesina *et al.* (1999) look at a sample of 20 Latin American and Caribbean countries. They conduct a survey of their budget systems and classify them as "hierarchical" or "collegial." Their empirical work suggests that more hierarchical institutions were associated with lower primary deficits in the 1980s and early 1990s (see also Stein *et al.* 1998; Hallerberg and Marier 2004; Filc and Scartascini 2007). Recent work on the region has contributed detailed case studies on the functioning and evolution of budget systems in several of the countries (Hallerberg *et al.* 2009). Overall, the empirical support for the fiscal institutionalist argument is impressive, given that these studies cover different time periods and country samples, and that they are based on different although related institutional measures.

One of the cases most cited in support of the fiscal institutionalist argument is Sweden. Prior to far-reaching institutional reforms, Sweden had a highly fragmented budgetary process that imposed little discipline on spending requests from line ministries, and where Parliament made substantial upward amendments to spending on a regular basis. In the early 1990s, the country was hit by a pronounced macroeconomic crisis, which led to a sharp deterioration of the deficit. A parliamentary commission tasked with reviewing budget procedures considered the unflattering findings of a study prepared by a finance ministry official that assessed Sweden's budget institutions on the basis of von Hagen's (1992) framework. It found that Sweden had the second worst set of institutions among thirteen countries, only slightly ahead of Italy (Molander 1999: 202–208).

Sweden implemented a wide range of changes in the mid-1990s (Hallerberg 2004: 160–166). The role of the minister of finance during budget preparation was strengthened with new powers to propose ceilings on the budget bids of line ministers (Blöndal 2001). The move to top-down budgeting also changed the sequence of the parliamentary process (Wehner 2007). Parliament would from now on vote first on budget totals before deciding individual appropriations. The Finance Committee gained responsibility for the aggregate spending totals as well as frames for each of the 27 expenditure areas. Based on the work of the Finance Committee,

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fifteen sectoral committees then make allocational proposals within their approved ceilings. Sectoral committees may propose to shift funds between items within an expenditure area, but they may not breach the total set for that area. In effect, a hard budget constraint has been imposed on sectoral committees.

By any standards, Sweden managed an impressive fiscal turnaround. The gap between general government revenues and expenditures had widened dramatically at the beginning of the 1990s, with the deficit exceeding 11 percent of Gross Domestic Product in 1993. By the end of the decade, the economy had stabilized and the government was back in surplus. Commentators attest that fiscal discipline has improved markedly (Blöndal 2001: 42; Molander 2001). The parliamentary process no longer produces spending increases on a regular basis (Wehner 2007, 2013). Sweden is one of the very few countries in Europe that has successfully contained deficits and the stock of debt in the wake of the 2008 financial crisis.

In addition to the common pool resource perspective, the role of budget institutions has also been examined in the context of fiscal adjustment. The focus in this literature is not on the *level* of spending, deficits, or debt, but on their *change* in response to an economic shock. Roubini and Sachs (1989) and Alesina and Drazen (1991) have shown that politically fragmented governments are less likely to adjust quickly, while Tsebelis and Chang (2004) find that the number of partisan veto players and their ideological dispersion relates to changes in budget composition over time. Some empirical papers find that budget institutions can help speed up fiscal adjustment (Alt and Lowry 1994, Poterba 1994, Guichard *et al.* 2007).

Overall, detailed comparative work on budget institutions has often had a regional focus, especially on Europe and also Latin America. This allows researchers to take into account the very different political and constitutional environments in which budget institutions are embedded. For instance, parliamentary government in Western Europe is combined with different electoral systems that affect the likelihood of coalition government and hence the choice between the delegation and commitment forms of fiscal governance (Hallerberg *et al.* 2009). Given the prevalence of coalition government in Eastern European countries, commitment-based approaches would seem most appropriate. The adoption of a suitable approach to fiscal governance is associated with better fiscal outcomes (Hallerberg and Yläoutinen 2010). Presidential systems in Latin America are arguably more suitable for centralizing budget preparation within the executive, but may require coalition building with legislative actors. Hence, executive-legislative relations are an important focus of scholarly inquiry into the role of budget institutions in these countries (Hallerberg and Marier 2004). The regional focus of much of the work in this literature thus reflects the importance of accounting for political context, especially the form of government as well as the electoral system and the party system.

Nonetheless, there remains scope to explore the extent to which fiscal institutionalist arguments generalize across more diverse samples. Work by Wehner (2010b, 2010c) on legislative budget institutions and fiscal policy outcomes is based on larger and more diverse samples, and yields results that are in line with the literature: countries where the legal framework prohibits legislative amendments to the budget that increase spending or deficits tend to have more prudent fiscal outcomes. There is scope to further expand the comparative ambition of research on fiscal institutions.

In sum, there is substantial evidence that the quality of budget institutions is associated with various indicators of fiscal performance. Of course, budget institutions are not randomly assigned, and none of these analyses can make a convincing claim to detect causal effects. The example of Sweden in this section demonstrates reciprocal causation: fiscal conditions on the one hand can provide the impetus for reform, while on the other hand the resulting institutional changes can also impose constraints that affect fiscal decisions. Since budget procedures are

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typically slowly changing, existing procedures are likely to constrain decision-makers at least in the short run.

The complexity of institutional bundles

More recent work highlights the importance of paying close attention to the nuances of designing specific budgetary procedures, and how different bundles of institutions combine to affect policy outcomes. In part, this work stems from a growing realization that fiscal institutions that are meant to constrain decision-makers and safeguard fiscal discipline can also have unintended consequences. For example, Milesi-Ferretti (2003) examines the effect of fiscal rules, which impose numerical constraints on fiscal aggregates such as deficits or debt (Kopits and Symansky 1998). His analysis suggests that fiscal rules may induce "creative accounting" rather than genuine fiscal adjustment, when they are imposed in a context of low budget transparency.

A body of empirical work documents the use of "fiscal gimmickry" in the European Union. For instance, Vincent Koen and Paul van den Noord (2005) find that Greece has made more extensive use of one-off measures and creative accounting than any other of the 15 countries in their study. Their calculations show that Greece qualified for membership of the Eurozone only because it embellished its public finance statistics so that it met, on paper, the required fiscal targets. Interestingly, Greece also has the lowest levels of budget transparency among the Eurozone countries. Alt *et al.* (2014) offer the first direct empirical test of Milesi-Ferretti's (2003) hypothesis, using stock-flow adjustments to proxy fiscal gimmickry, and confirm his prediction. They show that fiscal rules have harmful side effects when they are imposed in countries with poor budgetary reporting practices.

In response to these problems, and acknowledging that fiscal rules do not operate in isolation, international financial institutions and European policy-makers started to promote the creation of independent fiscal watchdogs to enforce fiscal rules (Debrun *et al.* 2009; Hagemann 2010; Cangiano *et al.* 2013). However, the experience of fiscal councils has been mixed. In some instances, independent institutions have greatly enhanced the credibility of fiscal policy, for instance the Central Planning Bureau in the Netherlands. Khemani (2007) shows that in India, intergovernmental transfers distributed by an independent body were insulated from partisan pressures. However, a number of fiscal councils have encountered significant difficulties when they became too independent for the taste of their governments, for instance in Canada and Hungary, as well as Sweden (Calmfors and Wren-Lewis 2011; Coene and Langenus 2011; Kopits 2011).

This discussion illustrates a growing sensitivity of fiscal designers that the effects of institutions may be more complex than often thought at first. Marcela Eslava's (2011: 662) summary of the current state of knowledge about the effect of numerical fiscal rules reflects this new awareness:

> [T]he response to these rules varies widely across countries, apparently in relation to other budgetary institutions […] and the political context; it is plausible that these differential environments may also change the incentives to engage in creative accounting and the feasibility of doing so. The evidence seems to suggest that effective rules would need to be more comprehensive, in the sense of imposing strict limits not only on deficits but also on debt, and covering the different possible sources for deficits. However, more comprehensive rules are also more complicated rules, and the possibility of enforcing them seems questionable. In that sense, it seems that the use of fiscal rules should be called into question in a more general sense.

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This realization has given rise to efforts to strengthen fiscal transparency. Principles for budget transparency were established by international organizations some time ago (Kopits and Craig 1998; International Monetary Fund 1998; OECD 2002). In the context of the recent Eurozone debt crisis, these efforts are receiving renewed attention (International Monetary Fund 2012). Whether this is enough to fulfill the promise of rules-based fiscal policy remains to be seen (Alt *et al*. 2014).

Other institutional "solutions" to the common pool resource problem have also not always held up to thorough empirical as well as theoretical analysis. One institutional adjustment that has been extensively promoted in recent years is the use of "top-down" decision-making procedures (Kim and Park 2006; Ljungman 2009). Under such a process, totals are set prior to the distribution of funds to sectors and programs. Von Hagen (1992: 36) initially promoted the use of top-down budgeting and suggested that fiscal discipline is enhanced when a vote on aggregate spending precedes allocational decisions. However, Ferejohn and Krehbiel (1987) demonstrate that such a process may sometimes result in relatively large budgets. Serritzlew (2005) extends and confirms their analysis. Alesina and Perotti (1996: 12) comment that this is "a useful warning against oversimplifying the effect of certain procedures."

Subsequently, von Hagen revised his initial claim and argued that it is not a reordering of the voting sequence that is decisive, as it has no impact on the share of the tax burden that actors consider, but rather the centralization of decision-making (Hallerberg and von Hagen 1997; Ehrhart *et al*. 2007). Indeed, the model by Ferejohn and Krehbiel (1987) assumes that the same actors make both the aggregate as well as allocational decisions. This is the key to a more refined argument about the benefits of top-down budgeting: The effect of the two-step process in terms of fiscal discipline depends crucially on who makes the first decision on aggregates. More specifically, top-down budgeting is likely to systematically contain overall spending only when the initial decision on aggregates is delegated to actors who are more likely to consider total costs than those who decide individual spending items (Wehner 2010b: 106–109). Sweden's redesigned parliamentary procedures illustrate the point.

In addition, there is limited work on how budget institutions combine with other political variables to influence policy outcomes. One aspect of this, discussed earlier, relates to how the party system affects the most appropriate form of fiscal governance (Hallerberg *et al*. 2009). But questions remain about how budget institutions interact with such political factors. For instance, Persson *et al*. (2007) argue that, in parliamentary democracies, proportional electoral systems increase the likelihood of coalition governments compared to majoritarian electoral systems. They also show that electoral competition inside coalitions engenders greater public spending than single party government. This suggests that budget institutions have an especially important role to play in mitigating a pro-spending bias under multi-party government.

Scholars have paid limited attention to how "size" fragmentation (the number of actors) is mediated by "procedural" fragmentation (the structure of the process in which they interact). Some authors have assessed the impact of both size and procedural fragmentation in the same study. Examples include Perotti and Kontopoulos (2002), Woo (2003), and Fabrizio and Mody (2006). However, none of them investigate the interaction between these different types of fragmentation. Some cross-national studies have considered how budget institutions interact with other variables, but not measures of size fragmentation (Hallerberg and Marier 2004; Alt and Lassen 2006a, 2006b).

There are only a few examples of empirical work that directly test the interaction between "size" and "procedural" fragmentation. Using data for a diverse panel of industrialized and developing countries, Wehner (2010c) shows that partisan fragmentation in the legislature is

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associated with higher deficits only when it is not moderated by limits on parliamentary amendment authority in budgetary matters. Focusing on executive fragmentation, Vanberg and Martin (2012) construct a "budgetary constraint index" for a panel of European countries and show that the number of government parties is positively associated with higher public spending only if budgetary institutions do not impose discipline. Looking at the interaction the other way around, De Haan *et al.* (2013) find that the effect of budget institutions on deficits is conditional on the ideological fragmentation of the government. Further work along these lines is important for advancing our understanding of the conditions under which institutional engineering might be most effective.

Conclusions

Theories of pork-barrel politics developed in the context of the United States have given rise to a cross-national literature on the common pool resource problem in budgeting. This literature proposes institutional solutions for settings where budgetary decision-making is fragmented across diverse decision-makers with limited incentives to internalize the cost of their actions. To contain a pro-spending bias in budgetary decisions, one solution is to centralize authority over fiscal policy in the hands of the finance minister or head of government. In the context of multi-party coalition government, this may not be feasible. Here, the use of binding fiscal targets, enshrined in coalition agreements, is an alternative option.

Empirical support for the predictions of the theoretical literature on the common pool resource problem in budgeting is impressive. Initial work focused on Western Europe, but increasingly geographical coverage has been extended to Eastern and Central European countries, Latin America and the Caribbean, as well as more diverse samples of countries. The conclusions of this empirical literature, despite its diversity in samples and measures, are consistent and strongly supportive of the theoretical literature.

However, a more recent strand of the literature cautions against an excessively naïve belief in the ability of institutional engineers to contain political pressures for fiscal profligacy. Experience with numerical fiscal rules suggests that they may have serious and systematic side effects—in the case of the European Union, countries with low standards of budget transparency have systematically circumvented these rules through creative accounting and, occasionally, intentional misreporting of fiscal data to statistical authorities. This highlights that particular fiscal institutions do not operate in isolation. Other institutional reforms, such as top-down budgeting procedures, also have more nuanced effects than initially anticipated. We need to understand much better how exactly specific institutions work as part of complex bundles, and under what conditions they are most likely to be effective. This also requires further analysis of interactions between budget institutions and political variables. Hence, the need for comparative research on fiscal institutions is far from saturated.

In the context of mounting pressures for fiscal consolidation and multiple initiatives at institutional engineering of the budgetary process by international organizations and supranational bodies such as the European Union, a better understanding of the effects and efficacy of proposed procedural "solutions" is arguably more urgently required than ever. Otherwise, procedural reforms guided by the latest public financial management fads may well deliver disappointing results, or do more harm than good. It is far from clear whether externally imposed institutional reforms will be as effective as those engendered by domestic political pressures (Andrews 2013). For instance, scholars should explore whether the credibility of fiscal rules as signals of commitment to fiscal discipline depends on whether external actors forced governments to adopt them.

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Many more questions remain. We still know rather little about the evolution and determinants of budget procedures, and why cross-country patterns differ so markedly. Often, there is a rush to include budget institution on the right-hand side of regression equations, instead of thinking about them as dependent variables as well. In Europe, such questions have been linked to the electoral system and the party system of a country. It is far less clear what this means in other contexts, such as presidential systems, as well as developing and other countries where informal institutions can be more important than formal procedural rules. Tracing the origins of budget institutions requires more systematic historical work, for instance on countries that have seen significant adaptations over time. The role of colonialism in spreading specific budget institutions also deserves attention in comparative inquiries (see Lienert 2003).

Another area for future comparative research involves diversifying the dependent variable. While fiscal policy is of central interest in examining the performance of political systems, other outcomes are arguably no less important. For instance, how do budget institutions affect the quality of public expenditures (Stasavage and Moyo 2000)? What is their effect on corruption and government accountability (Ablo and Reinikka 1998)? When are executive-favoring budget institutions, promoted in much of the fiscal institutionalist literature, inimical to democracy (Cox 2013)? It may well be that there are essential trade-offs between such different outcomes, which can be overlooked with an overly narrow research focus on fiscal aggregates. Comparative political economists are ideally positioned to develop such new perspectives.

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