

# Fiscal Discipline and the Budget Process

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The critical economic policy issue for many OECD countries, developing countries, and transition economies currently is fiscal consolidation, and the maintenance of long-run fiscal balance. Two related components underlie this general goal. First, several countries face the issue of deficit reduction, particularly those countries with high debt/GDP ratios. Second, it is becoming increasingly apparent that major reforms of the welfare system and, specifically, of social-security systems are critical ingredients of a long-lasting fiscal consolidation (see Alesina and Perotti, 1995a).

In the case of monetary policy, a constructive discussion has generated a widespread consensus about the benefits of different monetary institutions. Relatively few economists dispute the benefits of a certain amount of central-bank independence, even though different commentators and policymakers may disagree on the optimal degree of independence. Also a "contracting" approach has highlighted the benefit of inflation-targeting and of certain institutional relationships ("contracts") between the executive and the central bank. A similar theoretical and empirical discussion on the role of budget procedures and budget institutions is just beginning. In this paper we ask the following two questions: (i) Do budget procedures matter for the determination of the budget balance and its composition? (ii) Are there certain institutional reforms that one should feel comfortable in recommending?

Based on the relatively scarce empirical evidence available, we tentatively answer yes to the first question: budget procedures matter. On the second question we suggest that the

two critical areas of reform are: first, more transparency; second, a strengthening of the roles of the executive branch vis à vis the legislature, and of the treasury minister vis à vis the rest of the executive branch, in order to achieve a centralized and "top-bottom" approach to the budget process.

## I. Budget Institutions: Theoretical Issues<sup>1</sup>

We can define budgetary institutions as all the rules and regulations according to which budgets are drafted, approved, and implemented. Schematically, one can distinguish three types of "rules and regulations": (i) numerical targets on the budget, such as a balanced-budget law; (ii) procedural rules (such as voting rules) which regulate the preparation and legislative approval of the budget; and (iii) rules regarding the transparency of the budget. We briefly examine them in turn.

### A. Numerical Targets

In theory, the benefits of a numerical target for insuring fiscal discipline are obvious. A balanced-budget law, if enforced, eliminates persistent deficits induced by political distortions or by the politicians' opportunism and "short-termism."<sup>2</sup> However, two arguments weigh against strict numerical targets such as balanced-budget laws. One is a purely economic one: balanced budgets are not optimal, neither from the point of view of dynamic optimal taxation theory, nor from the point of view of Keynesian stabilization policies. According to the "tax smoothing" theory (Roberto Barro, 1979; Robert Lucas and Nancy Stokey, 1983) budget deficits and

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<sup>1</sup> For a much more extensive discussion of these issues, see Alesina and Perotti (1995b), upon which we draw here.

<sup>2</sup> For a survey of politico-economic models of budget deficits, see Alesina and Perotti (1995c).

surpluses should be used to smooth temporary fluctuations in expenditures and fiscal revenues. A balanced-budget law would force a suboptimal excessive volatility of tax rates.

The second argument against numerical targets is that they increase the incentives for creative and nontransparent accounting. Circumventing numerical targets by reducing budget transparency not only undermines the purpose of the targets themselves, but has potentially serious negative side effects. As we discuss below, lack of transparency in the budget process becomes, in the long run, a critical obstacle for achieving budget consolidation and expenditure control.

#### B. *Procedural Rules for Budget Approval*

In parliamentary democracies, the budget is prepared by the executive branch, which proposes it to the legislature, which (after possibly amending it) approves it. Voting procedures are crucial because they establish who has influence on the final budget document, as well as when and how. One can identify a trade-off between "hierarchical" and "collegial" procedures. "Hierarchical" procedures attribute strong prerogatives and powers to the treasury minister in the budget-preparation process within the executive branch; they impose limits on the number and type of amendments that the legislature can propose, emphasizing a "top-bottom" approach. "Collegial" institutions, on the contrary, emphasize "checks and balances" and democratic control in every stage of the process. For instance, they attribute substantial power to spending ministers vis à vis the Treasury and do not limit the extent of possible legislative amendments to the proposed budget.

There is a trade-off. "Hierarchical" institutions are more likely to deliver fiscal discipline, but on the other hand, they have a tendency to produce budgets that are tilted in favor of the majority. "Collegial" institutions have the opposite features. They guarantee the rights of the minority and emphasize "checks and balances," moderation, and compromise but may delay the implementation of "tough" fiscal adjustments when needed. Theoretical

underpinnings for these results can be found in the literature on voting rules in the budget-allocation process, particularly in David Baron (1989) and Baron and John Ferejohn (1989). These authors make a distinction between "closed rules" and "open rules." A closed rule is one in which a proposal made by the agenda-setter (a member of the legislature) has to be voted up or down, with no amendments. If it is voted down, another agenda setter is chosen (randomly) from the legislative body. With an open rule, the proposal made by the agenda-setter can be amended from the floor. Clearly, closed rules attribute more power to the agenda-setter. These authors show the following: (i) With an open rule, typically more than one vote is necessary to approve a budget, while with a closed rule the first proposal is always approved; thus, this result can be interpreted as saying that open rules create delays in the budget-approval process. (ii) Closed rules lead to the adoption of budgets in which the benefits of the budget allocations are concentrated on the bare majority (50 percent + 1) of the legislature; with open rules, instead, benefits may be spread out on a wider majority. (iii) Within the majority, the benefits of the budget are distributed more equally with open rules.

These results clearly highlight the nature of the trade-off between open and closed rules: no delays with closed rules, but more equal distribution of benefits with open rules. In reality, the agenda-setter within the government is the treasury minister, and the executive is the agenda-setter in the legislative approval process. Thus, closed rules are those that limit the prerogatives of spending ministers in amending the proposals of the treasury in the intragovernment preparation phase; also, closed rules impose limits on the types of amendments that the legislature can propose. For instance, in several countries the legislature can propose amendments on the composition of the budget but not on its balance. Within the government, spending ministers are more responsive to pressure from specific groups who benefit from certain spending programs. The treasury, instead, has (or should have) more incentives to internalize the gov-

ernment budget constraint and is relatively more responsive to the interests of the average taxpayer rather than of any specific pressure group. Special-interest groups, who want to increase spending on specific items and do not internalize the budget constraint, are even more likely to find an expression in the legislature. Thus, constraints on legislative amendments reduce their influence.

In addition to agenda-setting, the order of voting may also influence the outcome. For instance, one may argue that voting first on the total amount of spending and taxation and then on its composition should improve fiscal discipline. The alternative procedure would, instead, create incentives to resolve struggles over allocation with an increase in the overall size of the budget. However, Ferejohn and Keith Krehbiel (1987) argue that this result may not always hold, if when voting on the budget size, the legislators strategically compute the implication of their vote on the following vote on composition.

### C. Transparency

The budgets of modern economies, particularly those of countries with large public sectors, are very complex. Politicians typically do not have an incentive to adopt the most transparent practices. Lack of transparency helps to create confusion and ambiguity on the real state of public finances, by hiding as much as possible of the current and future tax burdens, overemphasizing the benefits of spending, and underestimating the extent of current and future government liabilities.

Two theoretical arguments imply that politicians will generally choose to be ambiguous. One is the theory of "fiscal illusion" (James Buchanan and Robert Wagner, 1977), according to which uninformed and naive voters underestimate the costs of current and future public programs, particularly when budgets are not transparent. Second, even with rational voters, strategic ambiguity may create an advantage for the policymakers in pursuing their goals (see e.g., Kenneth Rogoff, 1990). While this literature makes an interesting general point, it is several steps removed from the actual practices of "creative accounting."

Once the incentives for policymakers to be ambiguous in the budget process are well understood, one is left with two difficult questions: What are the effects of lack of transparency on the budget? And what is to be done about it?

A variety of "tricks" in the context of untransparent procedures are typically used:

- (i) Optimistic predictions on key macroeconomic variables (growth, inflation, unemployment, interest rates) in order to overestimate revenues and underestimate outlays. At the end of the year the "unexpected" deficit can then be attributed to "unforeseeable" exogenous shocks.
- (ii) Optimistic forecasts of the effects on the budget of various new policies.
- (iii) Creative and strategic use of what is kept in and off budget.
- (iv) Strategic use of budget projections. Often in budget discussions fiscal adjustments are calculated relative to a baseline: by inflating the baseline politicians can claim to be fiscally responsible, avoiding unpopular cuts.
- (v) Strategic use of multiyear budgeting, whereby the really tough policies are systematically postponed to year 2, 3, or 4 of the plan and never implemented, since multiyear plans can be revised every year.

Different countries may follow different practices of creative accounting and use them to different degrees. An interesting case is Italy, which Vito Tanzi (1994) identifies as a country with one of the least transparent budget procedures in a group of OECD economies. Also, in Alesina et al. (1996), we argue that lack of transparency is one of the critical factors which has led to the difficulty of enforcing fiscal discipline, particularly expenditure control, in Italy.

In summary, this discussion suggests that (a) the presence of laws that establish limits on the deficits may contribute to enforce fiscal discipline but may also create incentive to reduce budget transparency; (b) "hierarchical" voting procedures may enhance fiscal discipline, but reduce "checks and balances"

throughout the budget process; and (c) lack of transparency makes fiscal discipline and expenditure control harder to achieve.

## II. The Empirical Evidence

Budget institutions vary across countries. Thus, in principle, they can be used as an explanation for the large cross-country differences in fiscal performance. For example, current debt/GNP ratios within the OECD group of countries vary from almost 130 percent to less than 30 percent.

Before even beginning to pursue this enterprise, however, one has to worry about an issue of endogeneity. Are budget institutions really exogenous, or are they explained by other variables and, in particular, by previous fiscal performance? It is, indeed, quite plausible that in the medium-long run unsatisfactory fiscal performance may lead to institutional reforms. However, since it is relatively costly and complex to change institutions, the latter have to become very unsatisfactory before a consensus is reached for changing them. Thus, at least in the short-medium run, budget institutions can be considered exogenous. Nevertheless, as will become clear below, the empirical literature on the topic has almost completely ignored this issue, and an important next step in this research area is tackling the issue of endogenous institutional reforms. The relatively scarce empirical work on this topic has focused on European economies, Latin American countries, and U.S. states.

Jurgen von Hagen (1992) and von Hagen and I. J. Harden (1994) study countries that are members of the European Union. Based upon an analysis of budget legislation, they construct several indexes which rank national budget procedures from the most hierarchical to the most collegial and from the most transparent to the least transparent. They use a comprehensive index, so a country can rank high on the index either because it has hierarchical voting procedures or because it has very transparent procedures. For instance, France and Germany have "high" values of the index, but for very different reasons. In France the high value of the index is due mostly to the strong role of the prime

minister and to the voting procedures; in Germany the high value of the index is mostly due to the transparency of the budget. Von Hagen (1992) shows that, in the 1980's and early 1990's, budget procedures that are more hierarchical/transparent were associated with more fiscal discipline, as measured by conventional indicators. Von Hagen and Harden (1994) build upon these results, looking at many other fiscal variables but using the same index. Interestingly, they show that countries with more hierarchical/transparent procedures achieve more fiscal discipline but do not exhibit a worse performance in terms of output stabilization. Von Hagen (1992) also tests whether the emphasis and reliance on multiyear budgeting improves fiscal discipline, with inconclusive results. This is consistent with our previous discussion: on the one hand, multiyear budget plans can be useful in designing a multiyear fiscal adjustment; on the other hand, they may provide the means for always postponing tough policies, undermining the adjustment effort.

In Alesina et al. (1995) we test similar ideas on a sample of almost all Latin American countries from 1980 to 1993. Information about budget legislation and actual practices are obtained by a survey: budget directors of different countries answered a detailed questionnaire about budget legislation and practices of their own countries. The advantage of using questionnaires, in addition to a study of the legislation, is that with a survey one can capture "de facto" procedures, which may differ, even substantially, from the letter of the law. The empirical results are quite consistent with those of von Hagen on European countries: after controlling for several economic determinants of budget deficits, more hierarchical/transparent procedures foster fiscal discipline in Latin America. In Alesina et al. (1995) we also try to evaluate which components of the index have more influence on fiscal outcomes. The existence of a binding macroeconomic program voted *before* the composition of the budget is discussed is very important. Hierarchical voting procedures (in particular, limits in the power of the legislature to amend the budget) are also critical. However, the measures of transparency are rather rough, and results on this particular point are

inconclusive. These results on transparency probably say more about the difficulty of measuring it, than about its effect on fiscal discipline.

The two papers by von Hagen and Alesina et al. (1995) share some common problems. First, they do not consider other politico-institutional determinants of budget deficits, beyond the indexes of budget procedures. For example, government stability, party fragmentation, and electoral systems are variables that are likely to influence the fiscal balance (see Alesina and Perotti [1995c] for a survey). The problem is that a study of the effects of these variables is necessarily cross-country. Thus, it is difficult to assess the role of several institutional variables using a sample of 10–20 countries. Extending the sample of countries has two problems: data collection, since the construction of these indexes of budget procedures is quite laborious, and more fundamentally, a problem of heterogeneity of countries and institutions.

A second issue left open is that of institutional change. These studies are almost exclusively cross-country comparisons; it would be useful to conduct a time-series analysis in which fiscal performance and institutional change have feedback to each other. Third, the indexes used are fairly aggregated and do not measure well certain aspects of procedures. In particular, the transparency of the budget, although very important in practice, is very hard to quantify for statistical analysis. Fourth, an interesting question is whether procedures *create* fiscal imbalances or postpone adjustments to exogenous fiscal shocks. For example, much of cross-country variance in fiscal performance in OECD countries appears after the large shocks of the mid-1970's. Since institutions did not suddenly change in the mid-1970's, a strong possibility is that procedures do not create deficits, but make it more or less difficult to react to exogenously created fiscal imbalances.

James Poterba (1994) focuses precisely on the reaction to fiscal shocks, looking at U.S. states, which have different budget laws. In particular, different states have stricter, softer, or no balanced-budget laws. While many states cannot, by law, plan to run deficits, fiscal

deficits do materialize as a result of unforeseen falls in revenue or spending increases. Poterba studies whether different types of balanced-budget laws affect how vigorously and quickly states respond to unforeseen fiscal shocks. He finds that budget laws matter: states with weak anti-deficit rules respond more slowly to fiscal shocks. Thus, he concludes that “fiscal institutions affect the short-run pattern of taxes and expenditures.” James Alt and Robert Lowry (1994), using a somewhat different procedure, reach similar results on the same point.

Thus, according to these papers, the critical role of procedures is to make fiscal adjustments more or less prompt and vigorous. Note that this hypothesis is the analogue of the results concerning the effects of government fragmentation on fiscal deficits. Both the results of Poterba (1994) and Alt and Lowry (1994) on the effects of “divided government” in American states and those of Nouriel Roubini and Jeffrey Sachs (1989) on OECD countries reach similar conclusions: government fragmentation does not create budget deficits, but delays adjustment when negative fiscal shocks occur.

### III. Institutional Reforms

One can draw a few tentative lessons from the previous discussion:

1. Balanced budget laws for national governments are probably not a good idea. They introduce too much fiscal rigidity and create incentives to reduce transparency to circumvent them. On the other hand, the results by Poterba (1994) and Alt and Lowry (1994) suggest that balanced-budget laws for subnational governments may achieve, at least in part, a desirable effect. Thus, an interesting hypothesis is that balanced-budget laws should apply to subnational governments, but not to national governments.
2. Countries that face the prospects of several years of fiscal austerity in order to reduce deficits and debt/GNP ratios should adopt “hierarchical” procedures. In particular, this requires: (a) increasing the prerogatives of the treasury minister within the

government; and (b) adopting "closed rules" for budget approval and restricting legislative amendments. It is also almost surely a good idea first to require an approval (without amendments) of the balance and total spending proposed by the executive and then to discuss the composition. Legislative amendments should be possible only on the composition. One may even require qualified majorities (say two-thirds) to reject the budget proposed by the executive.

3. Budgets should be as transparent as possible. Unfortunately, it is very difficult to achieve transparency with detailed legislation. In fact, complicated legislation may be counterproductive by making procedures more cluttered. A few general principles, however, may increase transparency. First, the executive should present a single budget document, with all the relevant policies included. The legislature, and the public, should be able to see in a unified document the entire fiscal maneuver. Second, countries should move toward budgets that cover the general government, rather than the central government alone. This, of course, presents difficult technical problems and may involve different forms in different institutional settings (for instance, in federal or nonfederal countries). Third, the role of multiyear budget plans should be de-emphasized, forcing the discussion on what to do next year, rather than on what to do three years down the road. Fourth, government forecasts and projections should be verified by independent agencies, preferably non-public. The same agencies should also verify the government's estimates of the budget impact of major changes in taxation or spending programs.

In the end, it should be clear that no institutions will (or should, perhaps) prevent a government or a legislature from running deficits, if this is what they are really determined to do. What one can ask of budget procedures, however, is that they do not create obstacles to governments that want to be fiscally responsible.

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