Chapter 3
Aggregate Fiscal Discipline

Controlling total expenditure is an essential purpose of every budget system. There would be no need for governments to budget if total spending were merely the sum of all claims on public resources. Budgeting is ubiquitous because claims always exceed what government is able or willing to spend. Without limits on the totals, unconstrained demands would likely result in chronically high deficits and a progressive rise in the ratio of tax revenues and public expenditure to GDP.

Aggregate fiscal discipline pertains to all key measures of fiscal performance: total revenue, the financial balance and the public debt, in addition to total spending. It makes little sense to establish spending constraints without also deciding revenue totals, budget surplus or deficit, and the debt burden. Typically, therefore, spending discipline is accompanied by constraints on other budget aggregates. If it isn’t, the government may find it easier to meet deficit targets by allowing revenues to rise than by reducing public expenditure.

Constraining the totals is not easy because claimants have a strong incentive to demand all they can get from government. For most claimants, the benefits ensuing from higher government spending outweigh any resulting increase in their tax burden. Inasmuch as program benefits tend to be concentrated while the tax burden is dispersed, particular beneficiaries have more net gain from demanding additional spending than by advocating fiscal constraint. These unbalanced incentives lend self-interested claimants to demand more resources than they would want govern-
ment to spend. This “common pool” or “tragedy of the commons” problem is exacerbated when programs are debt financed and the government shifts costs to future taxpayers. What constrains claims on the budget is not only the prospect of higher tax burdens (or other costs such as rising inflation or weaker economic growth) but the impossibility of all claimants getting what they want. This impossibility is rooted in a fundamental condition of government: resources are more constrained than demands. Giving everybody what they want would exhaust current revenue and the government’s capacity to borrow. To counteract the inclination of claimants to push for more, governments constrain the spending totals. The question is not whether spending totals should be constrained, but how hard a constraint should be applied. Enforcing aggregate fiscal discipline is a contest between claimants and controllers; the latter can prevail only when decisions on spending totals are made somewhat independently of annual demands on the budget, and when these decisions are enforced by budget rules that limit what claimants can ask for and get, and when controllers are armed with roles and authority than enable them to enforce fiscal discipline. To the extent that budgetary rules and roles differ among countries, governments vary in their capacity to maintain aggregate fiscal discipline.

This chapter discusses aggregate fiscal discipline in the light of contemporary public expenditure management (PEM). The next section discusses the evolution of aggregate spending practices over the past century. It is followed by a consideration of the conditions that reinforce aggregate discipline: institutional arrangements, informational flows, and resulting behavioral changes.

The Three Stages of Aggregate Budget Policy: Lessons from Experience

There are important differences between PEM and previous approaches to aggregate fiscal discipline. PEM builds on and deviates from two earlier doctrines—the balanced budget norm and dynamic fiscal policy.

Prior to World War II, virtually all democratic regimes embraced the balanced budget norm. The operative rule was that spending during a fiscal year should not exceed that year’s revenue. Governments differed in applying this rule: some applied it only to current revenue and expenditure, others to investment income and expense as
well. Some included money carried over from previous years in calculating available revenue, others included only funds received during the fiscal year. The balanced budget norm did not distinguish between periods of economic growth and stagnation, nor did its time horizon extend beyond a single fiscal period to a full economic cycle. Because it was rigid, the balanced budget norm was not always adhered to. Few countries managed to keep total spending within revenues during wartime or recession; some even had difficulty during good times. But although the norm often was dishonored in practice, governments paid it lip service as the right thing to do. Moreover, even when the budget was imbalanced, governments used the norm to constrain spending demands.

Inasmuch as prewar governments were relatively small and tax rates were relatively low, much of the burden for maintaining balance fell on the expenditure side of the budget. Balance was enforced by ex ante controls on the items of expenditure. Spending control was centralized and reached individual transactions, such as decisions on hiring personnel and purchasing supplies. Moreover central controllers in the finance ministry or similar organization were empowered to block spending that was not authorized in the budget, was deemed by them to be unnecessary or wasteful, or that would, in their judgment, unbalance the budget. Some governments went a step further and required that all spending actions be approved in advance by central controllers. The rationale was that total spending could be effectively constrained only if particular spending items were controlled. With the bulk of public funds spent on the running costs of government, controlling the items of expenditures usually was a manageable task.

The strict budgetary balance norm was superseded after World War II by a flexible rule that allowed the totals to accommodate cyclical changes in economic conditions and secular changes in government policy. The new rule came in several versions. One was that government should maintain balance over the course of an economic cycle; another was that total government spending should not exceed the revenues government would take in if the economy were at full (or high) employment. Governments differed in the extent to which dynamic fiscal response should result from built-in stabilizers or from discretionary fiscal policy. Over time,
dynamic fiscal policy came to mean that government should act to reduce the gap between actual and potential output. Even when the economy was strong, deficit spending was common in many democratic countries, along with a steady updrift in the ratio of public expenditure to GDP. With aggregate constraints loosened, claimants had the upper hand in demanding more from government. Claimants also were advantaged by changes in budgetary rules and roles, for in many countries, spending items were consolidated into broad categories, and the government shifted emphasis from preaudits and external control to postaudits and internal controls. These and related changes enabled spending agencies to use budgeted funds without obtaining central approval, thereby reducing the authority of central controllers to intervene in agency spending decisions.

Spending demands were strengthened in most industrial democracies by a fundamental change in the composition of national expenditure, with much more spent on transfers to households and relatively less on consumption and investment. The changing mix of expenditures weakened aggregate fiscal discipline and promoted dynamic fiscal policy. An increasing portion of public expenditure was determined by statutory formula rather than by annual budget decisions. This portion of the budget has to be spent regardless of other claims on public resources and whether or not government has sufficient revenue to cover the mandated entitlements. For example, governments typically are required by law to pay social security and other pension claims, regardless of the overall condition of the budget. In many countries, these payments are funded by statutory or permanent law, not by annual appropriations. Moreover, the year to year rise in statutory payments often exceeds the incremental increase in tax revenues, forcing governments to raise the tax burden and/or accept deficit spending. Most importantly, the rise in transfer payments has made public expenditure much more sensitive to changes in economic conditions.

Aggregate fiscal discipline was a casualty of these changes. Government outlays soared in virtually all democratic countries. In OECD countries, they averaged 28 percent of GDP in 1960 and about 40 percent two decades later, a growth rate in excess of one half percentage point a year. In many countries, higher expenditure...
and lax fiscal discipline were justified in terms of the economic and social gains achieved through government expansion and flexible fiscal responses.

Whatever its virtues, an accommodating fiscal posture was called into question by the deterioration in economic performance of most industrial countries after the oil shocks in the mid-1970s and early 1980s. With economic improvement no longer taken for granted, many countries encountered increased political resistance to tax increases. High deficits came to be seen as structural problems that persist even when the economy recovers, not as cyclical responses to short-term economic difficulties. One after the other, developed countries concluded that they had to exert more discipline over the budget aggregates, including total public expenditure.

In seeking to reassert fiscal discipline, governments had to devise new approaches that differ from both the balanced budget rule and accommodating fiscal policy. A strict balanced budget requirement is unworkable because the budget is sensitive to economic fluctuations and cannot be kept in balance when output falls and unemployment rises. A zero deficit norm would be violated during most (and in some circumstances all) years of the economic cycle, not only during recession but also in its aftermath. When recession ends, its impact on the budget lingers for some time, because revenues remain lower and interest charges and certain transfer payments remain higher than what they would have been in the absence of the downturn. Some countries have redefined the balanced budget rule to focus on the primary balance, which excludes interest payments. During periods of sustained economic growth, when the deficit recedes and the budgetary effects of the previous recession dissipate, some governments renew their commitment to strict budgetary balance, but then they are jarred by the next recession into realizing that this rule cannot be enforced during economic downturns.

If the balanced budget norm is an unsustainable policy guide, so too is an accommodating fiscal posture and lax financial discipline. Some countries have come to the conclusion that active demand management is not a viable option when structural budget deficits are high; many now regard prolonged fiscal imbalances as a drag on their future economic capacity. Almost all perceive that the once-com-
mon distinction between cyclical and structural deficits is misguided because one year's cyclical deficit often worsens future structural imbalances. There are both fiscal and political reasons for the structural difficulty of fine tuning cyclical budget policy. Cyclical deficits add to spending demands on future budgets by raising interest charges and other payments. Moreover, when a government loosens the purse strings by permitting cyclical deficits, it changes the behavior of politicians and others with an interest in higher spending. Cyclical policy strengthens the hand of those who justify higher spending in terms of short-term improvement in economic well-being; and it spawns incentives to engage in creative bookkeeping practices that veil increased public spending and deficits.

When the government has an accommodating posture, fiscal discipline is loose both when the budget is formulated and during its implementation. In the 1970s and the 1980s, it was not uncommon for within-year changes to be greater than those made between budget years. When this occurs, the budget appears out of control, overtaken by exogenous circumstances such as worse-than-expected economic performance. The budget no longer does what it is supposed to do—decide the totals.

Faced with the impracticability of a strict balanced budget rule and the undesirability of accommodating budgets, industrial democracies have muddled through to a targeting strategy that permits controlled deficits that are expressly set by the government and are enforced through spending limits and other budget rules. Like the balanced budget rule, targets are fixed rather than accommodating, but unlike this norm they usually are decided by the government, not by an a priori norm.

Most early targets—those announced in the 1980s—were political statements, not operational policies, that were only loosely linked to the budget and lacked strong enforcement mechanisms. Often, the announced targets were unrealistic; even with genuine effort, they could not be achieved. They typically focused on short-term outcomes rather than on longer-term fiscal stabilization. Although they generally were ineffective, the first-generation targets signaled important changes in government policy. They rallied public support for a tougher fiscal stance and put claimants on notice that the era of lax spending control was over.
Some countries have achieved temporary success in disciplining the totals when the economy was robust, but they have been compelled to ease aggregate fiscal controls when the economy has weakened or spending pressures have escalated. According to a report by the U.S. General Accounting Office, four countries (Australia, Germany, Japan, and Mexico) that managed to restore fiscal balance during the 1980s experienced resurgent deficits during the early 1990s, demonstrating that although “significant structural improvement in fiscal policy is possible in modern democracies...such progress is difficult to sustain.”

The ineffectiveness of the early targets has let to more sophisticated approaches that integrate target-setting with formulation and implementation of the budget, specify constraints on revenue, spending, the deficit, and (in some countries) the public debt, establish subtargets for major spending sectors, and take account of cyclical gyrations in fiscal outcomes. It will take years of experience, through one or more economic cycles, before the impact of aggregate fiscal constraints on budget outcomes can be assessed.

Implications for Types of Fiscal Constraints

For fiscal limits to constrain revenue and spending decisions, they must be imposed before the budget is formulated. In contrast to the balanced budget era, when unwritten constraints sufficed because they were widely accepted, now the constraints are formal and explicit. Moreover, in contrast to the Keynesian era when revenue limits were set (and often changed) in the course of making and implementing the budget, the current emphasis is on setting them in advance, and independently of annual budget decisions.

Aggregate constraints take many forms, ranging from constitutional limits on the power of government to tax, spend or borrow to indicative statements that set forth the government’s fiscal posture but are not legally binding. The constraints may be self-imposed or externally prescribed through conditions set by international organizations or other entities. Some limits are established one year at a time, others extend to the medium-term (3-5 years) or beyond. The constraints may pertain only to the deficit or cover other fiscal aggregates. They can be expressed in money terms, as rates of change, or as percentages of
GDP or of other indices. They can be confined to the aggregates or cover major spending categories (such as sectors, portfolios, or budget functions) as well. The constraints may deal only with formulation of the budget, or they may include mechanisms for limiting parliamentary action and implementation of the budget. They may have tough enforcement mechanisms that entail corrective action if the constraints are breached or they may not require any intervention.

Because of their variety, the constraints cannot be displayed in a single table. This section maps out some of the alternatives available in designing and implementing aggregate fiscal discipline.

**Permanent Versus Annually Reset Constraints**

In seeking to discipline the aggregates, government may decide to operate under fixed rules that continue in effect from year to year, or according to a process in which new decisions are taken on by the aggregates each year. The rules may be prescribed by constitution, statute, international agreement, or some other binding decision. The Maastricht criteria for the European Monetary Union are in this category, as is the American Gramm-Rudman-Hollings law enacted in 1985. A somewhat more flexible approach is to decide the limits each year and then to consider budget estimates within the agreed constraints. In Australia, the forward estimates are the authoritative starting point for considering departmental bids for resources; in Sweden’s reformed budget system, the totals are decided by the government and parliament each year, before work commences on the annual budget. Another variant comes from New Zealand where the government presents a policy statement to parliament several months before it submits the annual budget. This statement indicates the government’s fiscal objectives for the medium-term and longer; it is updated half-yearly, as well as during the runup to national elections.

At first consideration, it may appear that the more constrictive the constraint the more effective it is likely to be in controlling the aggregates. Indicative statements would appear to be considerably less effective because they do not formally bind the government and no specific action (other than revision of the statement) is necessary when fiscal conditions veer off course. Yet there may be circum-
stances in which annual constraints have greater influence than permanent ones, and indicative policies are more effective than constrictive rules. This argument rests on two premises: first annual policies tend to be more realistic and achievable than permanent rules; second, annually established constraints may have more political support than standing rules which have not been endorsed by current politicians. No matter how hard they are, constraints cannot be achieved if they are unrealistic or lack political support. When both conditions are lacking, politicians may conspire to evade the constraints by delaying payments, resorting to extrabudgetary arrangements, underestimating expenditures, and other bookkeeping tricks.

Constraints tend to break down over time. When they are fresh and backed by political commitment, the constraints may discipline budgetary decisions. But as they age and encounter new conditions, they often lose effectiveness. Moreover, over time spenders learn how to circumvent the controls while paying lip service to them. Periodically, therefore, fiscal constraints may have to be renewed to restore their effectiveness.

The choice between constrictive and indicative rules depends on institutional conditions, which vary from country to country. This conclusion is elaborated in the next section, but can be summarized here as follows: Indicative constraints effectively discipline the aggregates when institutional arrangements promote fiscal prudence. On the other hand, constrictive rules might be appropriate in countries when institutional arrangements promote or tolerate fiscal laxity. If this is true, fiscal discipline must come to grips with an anomaly: when hard constraints are most needed, they may be least workable; where conditions are most hospitable for fiscal constraints, they may be least needed.

**External Versus Internal Constraints**

This anomaly suggests that self-discipline may be in short supply in countries that need it the most. Ideally, democratic governments should establish and enforce their own fiscal rules, but when they are unable to do so, external pressure may have a salutary effect. Quite a few European countries have accepted fiscal austerity in order to meet the criteria for entering EMU. Over the years, many developing and transitional countries have constrained
their fiscal appetites in response to conditions imposed by IMF and other international organizations.

These pressures may work because they change the balance of political power within affected countries and enable politicians to shift the blame for taking unpleasant measures to outsiders. Nevertheless, external pressure may be a weak substitute for self-discipline because external controllers must rely on the government to implement and enforce the constraints. Some governments are adept at holding outside controllers hostage to their domestic interests, with the result that even with their best efforts, international organizations often do not always get the promised outcomes.

**Annual Versus Multi-year Constraints**

Budgets usually are made for a single year, and fiscal constraints usually are expressed as annual targets. However, one-year-at-a-time constraints may induce spenders to defer expenditures to subsequent years, enabling the government to claim that it has achieved the current targets while making it difficult to meet future ones. The tighter the fiscal constraints, the greater the incentive to avoid hard choices by postponing the day of reckoning. These considerations suggest that a medium-term expenditure framework is a useful, perhaps essential, instrument of fiscal discipline. When it is properly applied, a multi-year framework compels the government to assess the impact of current spending actions on future budgets. Of course, if, as is normally the case, the framework extends only to the next 3-5 years, spenders may have incentives to shift expenditures (or other actions that weaken fiscal discipline) to still later years. Nevertheless, the incentive and opportunity for politicians to break fiscal discipline diminish when the framework covers future years.

Australia’s forward estimates system described in Box 3.1 establishes the fiscal framework within which annual budget decisions are taken. Although they can be altered by the government, the approved forward estimates are the fiscal boundaries within which departmental spending bids are fitted. These bids are considered in terms of spending impacts on the forthcoming budget and on the forward estimates for the following three years.
Some countries that budget within an annual framework nevertheless consider the outyear implications of fiscal decisions. Sweden’s new budget system fits this model (see Box 3.2), but inasmuch as it has been in place only since the mid-1990s, there is insufficient evidence for assessing its effectiveness.
**Expenditures and Other Fiscal Aggregates**

In managing its finances, a government produces at least four fiscal results: total revenue, total spending, the deficit (or borrowing requirement), and the public debt. Governments that budget on a commitments basis also have data on the total commitments issued or outstanding. Separate aggregates may be calculated for loans guaranteed by the government and for other contingent liabilities. Finally, governments that publish consolidated financial statements produce data on assets, liabilities, and net worth. The various aggregates may pertain only to the central government, or to other portions of the public sector as well, such as social security, subnational governments, public enterprises, and other entities that normally are excluded from the national budget.

The various fiscal aggregates can be targeted in different ways: in money terms, as a percentage of the gross domestic product or of some other index, in real (inflation adjusted) terms, or as a rate (or amount) of change over a previous fiscal period. Expressing public expenditures and other aggregates as a proportion of GDP facilitates comparisons over time and with other countries, and recognizes that the affordability of a government’s spending depends on (among other measures) the volume of national output. Nevertheless, focusing on expenditures (or revenues) as a percentage of GDP may bias public expenditure upward. If the government seeks to stabilize public spending as a percentage of GDP, it may accept real spending increases when the economy expands but find it difficult to reduce spending when the economy stagnates. Over the course of an economic cycle, this pattern may result in a progressive rise in the ratio of public spending to GDP.

Constraining a single fiscal aggregate also is likely to generate distortions in budgetary behavior. If only the deficit is targeted, the government may contrive to meet the constraint by selling assets, postponing expenditure, or resorting to nonrecurring revenue sources. Moreover, a fiscal constraint confined to the deficit may impel politicians to meet the target by raising revenue rather than by cutting expenditure. A broad set of constraints that targets several fiscal aggregates may discourage this behavior, especially if the targets include the government’s net worth, a measure that is not affect-
ed by asset sales or by the shift in receipts or payments from one fiscal period to another. It should be noted, however, that few governments currently produce the consolidated financial statements needed to calculate net worth.

Many developed countries pay closer attention to the debt to GDP ratio than they once did. This development has been spurred by the steep rise in debt burdens and by the Maastricht Treaty which conditions initial membership in EMU on holding gross public debt below 60 percent of GDP. This ratio is an indicator of the sustainability of chronic budget deficits. In contrast to the deficit which measures financial balances within a short fiscal period, the debt to GDP ratio signals changes in financial condition over an extended period. A rise in this ratio means that the debt burden is increasing faster than economic output. This trend cannot be sustained indefinitely, and can be reversed only by curtailing annual deficits to a rate that is less than the rise in GDP.

The debt to GDP ratio usually is calculated on a gross basis; it measures the total owed by the government. This ratio is not reduced by money owed to the government or by other assets held by it. In contrast to the balance sheet which measures net worth (assets minus liabilities) the gross debt measures only liabilities, and only those liabilities that are in the form of debt. It is an incomplete measure of the government’s financial condition that does not reflect net worth. The government can lower the gross debt to GDP ratio by selling physical or financial assets and using the proceeds to repay a portion of the debt. This transaction would change the composition of assets and liabilities, but not the government’s net worth.

The gross versus net basis also pertains to constraints on total expenditure. Just about every national government obtains some income from user charges, state-owned enterprise, and other commercial type activities. If it accounts for finances on a gross basis, this income would be budgeted as revenue; if it uses the net basis, some or all of this income would be budgeted as an offset to expenditure. Netting versus grossing does not affect the size of the deficit, but it does affect total spending; hence, the issue is important when a government imposes a fixed constraint on total spending. The net basis is popular in some countries because it encourages spending depart-
The Swedish Government (and the public sector) have had recurring budget deficits since the mid 1970s. The typical response has been for the Government to adopt austere budgets which, through a combination of spending cuts and revenue adjustments, reduce the deficit to manageable size or eliminate it altogether. For example, in 1982, the Government implemented a "crisis program" that progressively reduced the deficit and briefly eliminated it by the end of the decade.

However, a recession in the early 1990s, combined with upheavals in financial markets, resulted in a budget deficit that reached approximately 13 percent of GDP, far higher than the imbalances experienced previously. At about the same time, a comparative study of budget practices (led by Jorgen von Hagen) concluded that Sweden's budget process was very weak compared to that of other European Community governments. It further found that lax budget procedures are closely correlated with higher deficits and a growing public debt.

Sweden introduced a reformed budget process in 1996 that has more than doubled its score on the von Hagen fiscal stringency scale from 25 to 58. Prior to the reforms, Sweden ranked 12th among the 13 EC member states on this scale; post reform, it ranks 3rd.

The centerpiece of the reforms is a new two-step budget procedure. In the Spring, the Government establishes a multi-annual expenditure ceiling for each of the next three years. The ceiling is expressed in nominal terms, and is subdivided into 27 expenditure areas. In the first years that it has been applied, the ceiling included a margin (equal to approximately 2 percent of central government expenditure) to cover overruns and unanticipated circumstances. The spending ceiling is a gross amount. The Government also submits an indicative spending ceiling for local governments.

The first stage of the process concludes with adoption of the spending ceiling by Parliament.

Stage two entails preparation of the annual budget bill by the Government and voting of appropriations by Parliament. Both the budget and appropriations must be within the pre-approved spending ceilings. As a result, preparation of the Government's budget has become more of a top-down process (though bilateral negotiations between line ministries and the Finance Ministry continue as before). In Parliament, work on appropriations is assigned to various committees, each with its own spending ceiling. In contrast with past practices, budget amendments must have offsets, so that total spending is within the ceilings.

The reformed process provides for close monitoring and periodic reports on budget outturns, as well as for handling expenditures in excess of the approved amounts.

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**Box 3.2: Strengthening Fiscal Discipline in Sweden**

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ments to charge users for the benefits they receive while making it easier for the government to adhere to a constraint on total spending. Sweden, however, recently rejected the net basis; it now budgets for gross government spending. In the Swedish system, amounts paid to the European Community are budgeted as expenditures and amounts received from it are budgeted as revenues. The two flows are not netted out. This approach was selected by Sweden because it emphasizes control of total spending.

**Controlling the Main Expenditure Components**

Maintaining aggregate fiscal discipline obviously requires that the government control the budget’s totals. Decisions on the elements of expenditure would come later, in the course of preparing estimates and reviewing expenditure bids. Arguably, however, effective control of spending requires that decisions on the totals be coupled with decisions on major subaggregates, such as sectors, portfolios, or budget functions. This argument rests on the notion that if agreement has not been reached on the main components, the government might be unable to withstand pressure to raise the totals when individual spending claims are considered. But if allocations to sectors or other major categories also are set, these subtotals would constrain the amounts that claimants may bid for.

Contemporary budget reform in developed countries suggests several approaches to constraining expenditure subcomponents. In Sweden’s new budget system explained in Box 3.2, when the aggregates are decided, spending is broken into 27 sectors; each is given its own allocation. When Parliament votes appropriations, it must adhere to the agreed sectoral limits. Australia’s forward estimates are structured into 17 portfolios, each of which is the responsibility of a Minister. While the Government may increase spending in the course of developing the budget, the expectation is that ministers will first look for savings in their portfolios before seeking additional funds. In the United States, when Congress adopts a budget plan, it divides total spending into approximately 20 budget functions. These allocations, however, are indicative; they do not constrain subsequent appropriations.

The question of whether it is desirable or necessary to couple sectoral and aggregate limits may turn on the cohe-
siveness of the government. When budget making is highly centralized, the government may be able to keep to the agreed totals even though it has not made any sectoral decisions. But when the budget is decided by Cabinet in a collegial manner, or when Parliament authorizes more spending than was requested by the government, early controls on sectoral allocations may strengthen aggregate fiscal discipline.

**Institutions: Rules, Roles, and Information**

Maintaining aggregate fiscal discipline almost always entails changes in institutional arrangements; these influence the incentives and, therefore, the behavior as well, of claimants and controllers. The key requirement is that budgetary controllers be sufficiently powerful to enforce fiscal discipline; if they are not, claimants will behave as self-interested takers from a common resource pool—taking as much as they want until the pool is depleted.

**Rules**

Budgetary institutions are the rules according to which budgets are prepared, approved, and carried out. These rules may be formal or informal: formal rules spell out legal requirements for preparing, approving, and implementing the budget, as well as the types of information, the powers of the Finance Ministry and other participants, the scope of changes that may be made by the legislature, and adjustments that may be made during the fiscal year, in the course of implementing the budget. Informal rules pertain to the actual behavior of participants; these have a wider scope to the extent that formal rules are ignored or evaded, or do not specify how particular situations should be handled. The formal rules specify how the budget process should operate; informal rules specify how it actually does. For example, formal rules may provide for the government to intervene when spending exceeds targets, while de facto, the government may simply accept the additional spending without taking remedial action.

A growing body of empirical research demonstrates a close correlation between budget rules and outcomes. Although the research methods may appear to be somewhat deficient—they generally rely on questionnaire responses, subjective assessments by observers or participants, and crude weighting schemes—the fact that various studies concentrating on different
regions (Asia, Latin America, and Europe) have come to approximately the same conclusion adds to the strength of the findings.

Various studies have found a strong correlation between the stability and cohesiveness of the government on the one hand and the deficit and debt to GDP ratios on the other. A key finding is that fragmented governments (such as multi-party coalitions) have less capacity to assemble and maintain a majority in support of the tough measures needed to maintain fiscal discipline. Cohesive governments, in which a single party constitutes the government (in parliamentary regimes) or controls both the executive and legislative branches (in presidential systems) have greater ability to constrain the aggregates and withstand pressure to spend or borrow in excess of targeted levels. In general, the more parties that comprise the coalition, the less able the government is to establish and enforce stringent fiscal discipline. Aggregate discipline may be particularly difficult to maintain when (as sometimes happens in coalition governments) one party controls the finance ministry and another controls one or more of the major social portfolios.

The same vein of research, however, also indicates that the checks and balances of fragmented or divided government lead to less total spending than in majoritarian regimes. Apparently, when government is split, its capacity to expand programs is diminished, either because a majority is lacking to support the initiative or because parties do not want to vote for additional spending that might occur while they are out of power.

While these studies focus on broad political institutions, a more direct approach has been to examine the relationship between budget rules and outcomes. The relevant rules pertain to the three critical stages of budgetary decision and action: formulation of the government’s budget, review of the budget and appropriation of funds by the legislature, and transfer or supplementation of expenditures during execution of the budget.

In studying budget preparation rules, researchers have found that collegial forms of decision-making lead to more lax fiscal discipline than authoritarian rules. Collegiality refers to rules that give all ministers approximately an equal say in budget decisions, the finance ministry decides spending levels in bilateral negotiations with line
ministers, and the Cabinet collectively approves the budget. Authoritarian rules give a strong advantage to the Prime Minister (or the Finance Minister) who can overrule the demands of spending ministers in negotiating the budget. In these types of regimes, fiscal targets are likely to drive budget decisions, in contrast to collegial systems in which spending demands drive the fiscal totals. Authoritarian rules emphasize discipline and consistency, collegial rules favor compromise and consensus.

Differences also emerge during legislative action on the budget. Here the contrast is between restrictive procedures that bar amendments that would increase spending (or reduce revenues) versus open procedures that do not constrain budget amendments. An intermediate arrangement would permit amendments increasing spending provided that overall balance is maintained by requiring offsetting cuts in other expenditures. In open systems, legislative amendments are not matters of confidence; in restrictive systems, they may be. Given the localized political base of most national legislatures, it is highly likely that open rules would encourage amendments that increase total spending, and have an adverse effect on fiscal balance.

Finally, a distinction can be drawn between flexible systems that permit spending increases during execution and rigid systems that either bar such increases or require that they be consistent with agreed fiscal aggregates. Flexible systems tend to have liberal rules that permit the transfer of funds between votes or accounts in contrast to rigid systems that restrict such transfers. In some flexible systems, the government does not need to obtain legislative approval for spending increases until after the additional funds have already been spent, sometimes years later; while in rigid systems, any such increases must be approved in advance.

There are nuanced differences in the terminology and findings of various empirical studies, but inasmuch as they all point in the same direction, there are not significant; overall, the findings justify the conclusion that a government bent on enforcing aggregate discipline must do more than merely establish fiscal limits.

Roles
Budget rules are not self-enforcing. The fact that a government restricts certain actions that would weaken dis-
cipline does not mean that it follows the rules when they become so con-stra"n"ing as to prevent a political majority from getting its way. Except when they are inscribed in the constitution or in some superior law that cannot be changed by majority vote, restrictive rules can be brushed aside. The same politicians who make the rules can break them.

Why, then, don’t politicians change or breach the rules when they prove to be too constrictive? Why do rules make a difference at all? Part of the answer is that once budgetary rules are in place, politicians may pay a price for violating them. The rules change the incentives of politicians. Another part of the answer is that rules work when they have enforcers, that is, politicians and officials at the center of government who have the will and the authority to maintain adherence to the rules.

In virtually all countries, budget enforcement is centered in the finance ministry or the central budget organization. This unit has the lead role in maintaining aggregate discipline; it must be strong enough to withstand pressures to evade spending targets by removing some transactions from the budget or through other ploys, and to override the targets when politicians or sectoral interests regard them as too constrictive. There is good reason to believe that enforcing fiscal discipline depends on the strength of the finance ministry and its budget unit vis-à-vis other government entities. In general, the relative strength of the budget office is enhanced when it is located in a finance ministry that has broad governmental powers. Germany and Japan, for example, have powerful, encompassing finance ministries; over the full post-war period, they have been among the most successful in maintaining aggregate fiscal discipline. The German Finance Minister may be overruled by the Cabinet only when the Chancellor sides against him; Japan’s Finance Ministry has had extensive regulatory powers extending to financial institutions, securities, and other sectors, in addition to its powerful role in revenue and spending policy. But even in these countries, fiscal discipline has been undermined: in Germany, by spending pressures following unification; in Japan, by the deepest recession since World War II.

The targeting process and the changed composition of public expenditures have affected the manner in which the central budgeting organiza-
tion maintains fiscal control. In classical budgeting, the budget office reviewed detailed bids for resources and recommended the amounts that should be made available. It also policed implementation of the budget to ensure that public funds were spent only on approved items and that the amounts spent did not exceed authorized levels. In this model, controlling the totals was a byproduct of controlling the items. The budget office presumed that total spending could not be controlled unless the individual items were. Contemporary fiscal discipline is moving in the opposite direction. It emphasizes that the totals should be controlled independently from the parts; disciplining the totals must be a central responsibility; responsibility for spending items can be devolved to sectoral ministries or operational entities.

In some countries, the budget organization has disengaged from the items of expenditure and has taken the position that it can more effectively constrain the totals by concentrating on subaggregates, such as departmental running costs or total resources allocated to each portfolio. The central budget office may be willing to concede discretion over the spending items to various departments in exchange for firm limits on the total each may spend. This quid pro quo may promote allocative and operational efficiency, two key objectives of public expenditure management, in addition to enhancing aggregate spending discipline.

The United Kingdom and Australia are among the countries that have vigorously moved in this direction. Following a “fundamental expenditure review” of its operations in 1994, the U.K. Treasury staff was reduced by about one-quarter as it withdrew from various itemized controls that had been maintained for a century or longer, and sharpened its focus on macro-budgeting. In Australia, the Department of Finance introduced running cost arrangements that give departments control over operating resources in exchange for tighter controls over total spending and portfolio allocations. In these and other countries, the central budget office has devolved control over administrative expenditure while strengthening aggregate spending discipline.

Spending controllers deal as much with assumptions as with hard data. The typical budget baseline is composed by making assumptions con-
cerning future prices, program workloads, and other factors affecting expenditure levels. Estimates of the spending impacts of program initiatives and legislative actions rely on similar assumptions. One of the critical tasks of public expenditure management is ensuring that actual spending does not deviate significantly from projected levels. This is a difficult task which depends on government capacity to accurately measure the assumptions that drive its budget projections.

Building Support for Fiscal Discipline
Budget controllers cannot maintain fiscal discipline if they stand alone without strong allies in government. They need both political allies who accept the political risks of constraining public expenditures, and managerial allies who accept the imperative of operating within agreed constraints. It is unlikely that they will win every battle against wily and politically potent spenders whose weapons include proposals that hide the true cost of policy initiatives, resort to extrabudgetary funds, and bookkeeping arrangements that underestimate budgetary impacts. Under PEM, it is necessary to guard the budget against these and other devices. Ironically, as fiscal norms become tougher and more constrictive, budget claimants have greater incentive to evade them. Over the medium-term or longer, budget guardians will not be able to uphold fiscal discipline unless they have steadfast political support.

Politicians need incentives for buying into fiscal discipline. They must have actual or expected gains, such as success at the polls, acclaim in the media, or the conviction that they are doing the right thing. But incentives are not a one-way street; for every gain that accrues to politicians from exercising constraint comes the cost of cutting programs, raising taxes, or rebuffing claims on the budget. These costs must be manageable and (in some political calculus) less than the expected gains. Costs are made manageable by having realistic targets, spreading the constraints over a period of years, softening the aggregate targets, controlling net spending (total spending minus income from user charges or other earmarked revenues) rather than gross spending, and allowing relatively minor overshoots of the target. The common element in these approaches is that aggregate fiscal discipline may be
stronger when the constraints are a bit more accommodating.

**Opportunistic Budgeting**

Having appropriate budgetary institutions may be a necessary condition for disciplining the aggregates, but it is not always sufficient. Aggregate fiscal outcomes can be driven off target by exogenous factors that are weakly controlled by the government, if at all, or by endogenous factors such as opportunistic behavior by politicians and other budget makers. Exogenous conditions are considered in the next section; this section deals with opportunism that is stimulated by the very rules that purport to restrain politicians and others.

Opportunism is rife in budgeting, as in other economic transactions. Opportunism is self-interested behavior that undermines budgetary constraints. Politicians may want to run smaller deficits, but they also want to spend more and tax less. When rules try to prevent them from doing the latter, they opportunistically seek ways to evade or disable the rules. Without opportunism, there would be no need for strong rules; with opportunism, the rules might not yield the intended outcomes unless they are reinforced by external constraints.

Anyone who has managed public expenditure has encountered opportunistic behavior by politicians catering to voter preferences or by managers who want bigger budgets to carry out their responsibilities. The catalog of opportunistic budget tactics includes: under-estimating or hiding the costs of programs; selling assets and booking the income as current revenue; shifting payments back to the previous fiscal year or forward to the next; miscoding accounts so that money provided for one purpose is spent on another; paying liabilities with chits rather than with cash; accelerating tax collections; disregarding the liabilities of state-owned enterprises in budget statements; transferring balances in state-owned enterprises to government accounts; and labeling current expenditures as capital investments. A 1997 IMF working paper identifies 28 types of opportunistic revenue and expenditure actions that might be used by European Community countries to show compliance with the Maastricht deficit and debt rules.

When budgetary opportunism is carried out on a small scale, perhaps nothing needs to be done to stanch
it, especially if the rules strengthen aggregate discipline. Suppose, for example, that in response to constrictive rules, the government reduces the deficit, mostly by cutting pension benefits and in a small part by deferring some payments to pension funds. In this case, the rules have constrained expenditure, even though full compliance is lacking. Arguably, the government should settle for the real deficit reduction it has achieved without taking further steps to tighten the rules. On the other hand, a case can be made for tougher enforcement on the grounds that this small breach might well turn into a much larger one as opportunists become emboldened to devise bigger evasions.

Opportunists cannot be relied on to curb their self-interest. More rules, or clearer specification of their terms, might help somewhat, but as contract law demonstrates, rules alone do not put an end to opportunism. What is required is that the rules be accompanied by strong enforcement mechanisms. In some countries, the Finance Ministry plays this role, in others the supreme audit authority does. The checks and balances built into democratic political systems can dampen opportunism by enabling one branch to block the actions of the other, or to call public attention to the misbehavior. In presidential systems, an independent legislature can check executive actions; in parliamentary regimes, the legislature can have an effective watchdog role, even though it is not fully independent. In the United Kingdom, the nonpartisan Public Accounts Committee has played this role in recent decades; it has been joined by an array of standing committees which oversee and sometimes influence government actions. An independent central bank also can check budgetary opportunism, provided that it enjoys sufficient public esteem so that its voice can be heard above the din of political debate.

It is doubtful, however, that internal constraints suffice when willful opportunists seek to twist ambiguities or gaps in budget rules to their advantage. In president-centered countries the two branches often collude rather than check one another; in parliamentary systems, legislative committees often behave as sleepy watchdogs. In all countries, it is rare that the central bank challenges the actions of opportunistic politicians.
**External Constraints**

It may be appropriate, therefore, to supplement the internal controls with external constraints on budgetary opportunism. Constraints can be imposed by outside entities which monitor a government’s performance, by financial markets which punish imprudent budget policies, or by the accounting profession which promulgates standards and polices compliance. These and other external constraints are effective only when they are underpinned by transparent budgets which provide reasonably accurate and complete information on public finances.

In the wake of the EMU’s enforcement of the Maastricht norms, one can expect the role of international organizations in overseeing budgetary policies and outcomes to increase. This role has long been played by the World Bank and IMF in enforcing conditionality on loans and other forms of assistance. In many instances, however, international enforcers have been locked in a cat-and-mouse relationship with the recipient country, in which tough conditions have generated evasive responses.

There is some evidence (presented by Campos and Pradhan) that open financial markets contribute to aggregate discipline by penalizing countries for fiscal mismanagement. Open markets allow investors to swiftly withdraw capital whenever they fear that a large deficit might generate inflation and devaluation. Moreover, investors demand higher interest rates as a premium for taking the risk of placing funds in the country. In general, Campos and Pradhan conclude, the more open its financial markets, the smaller a country’s fiscal deficit will be. It may be the case that budgetary opportunists will devise means of hiding their tricks from vigilant financiers, but if they do so, the reactions that ensue when the legerdemain is revealed will punish the offending country even more.

Financial markets work well when budget documents and financial statements are transparent. But without robust accounting standards and attentive auditors and other monitors, transparency can be more of a slogan than a reality. As financial markets have become more closely interlinked, and outside institutions have become more involved, significant steps have been taken to elaborate and harmonize accounting standards across countries. These steps have been spurred by
efforts to discourage various types of fiscal opportunism.

In the future, pressure will increase to impose these standards on budgetary documents, not only on financial statements. Moreover, rules will be elaborated for the assumptions that underlie budget projections and for estimating the impact of policy changes on future budgets. The budget will be a battleground between opportunistic politicians and vigilant guardians.

**How Hard Are the Constraints? Entitlements, Risks, Cycles and Shocks**

Aggregate fiscal discipline is predicated on the notion that governments are the masters of their budgetary fate. It assumes that they can chart a fiscal course and can enforce hard constraints regardless of the conditions under which their budgets are formulated and implemented. In reality, however, governments often have weak control over the economic and political circumstances in which they operate. If the fiscal impact is big enough, exogenous changes can dislodge even the most obdurate government from its intended fiscal course.

There are degrees of hardness in fiscal constraints, as there are in all political decisions. To say that constraints cannot be maintained in all circumstances does not mean that they can be enforced in none. One of aggregate fiscal discipline’s valuable contributions to public finance may be to encourage the adoption of policies that reduce the budget’s exposure to external disturbances and thereby enable governments to attain more rather than less of their fiscal objectives. Doing so depends on the capacity of governments to design policies and programs in ways that limit risk before external circumstances force their hand. Remedial action almost always is too late when it is taken at the point of crisis or when the only acceptable options are those that would breach fiscal discipline.

Government budgets face four types of “bad news” that vitiate fiscal constraint: (1) the unbudgeted, unwanted, or unaffordable costs of open-ended entitlements; (2) contingent liabilities incurred in one fiscal period that become payable in a later (sometimes much later) period; (3) cyclical weakness in the economy that imbalances the budget; and (4) big shocks that jar government from its
intended course and destabilize the budget. The four sets of conditions are sequenced from those over which government has most fiscal control to those over which it has the least. A government can opt not to establish certain entitlements and can hedge against contingent obligations, but it may be unable to avoid the adverse budgetary impact of an economic downturn or the shocks resulting from major upheavals, such as the onset of war.

The four categories are closely linked. A government that spends much of its budget on entitlements is likely to be more affected by cyclical downturns than one that does not; a government that indemnifies firms or households for fiscal risks will be more exposed to political or financial shocks than one which adopts risk-averse policies. Despite these and other interconnections, discussing each category on its own sheds light on the problems contemporary governments face in maintaining fiscal discipline.

**Entitlements**

It generally is more difficult to enforce constraints on entitlements than on consumption or investment expenditure. The latter usually are definite in amount and are controlled by annual appropriations; the amount provided each year determines what is available for expenditure. Entitlements, however, typically are open-ended; there is no fixed limit on the amount to be spent. Moreover, the volume of expenditure is determined by permanent law rather than by annual appropriations. For many entitlements, the budget typically accounts for the amounts to be spent; for consumption and investment programs, the budget decides the amount to be spent.

Spending on annual entitlements often is driven by exogenous factors, particularly economic and social conditions, not by explicit budget actions. The effective decisions were taken years or decades earlier when the entitlement was established (or expanded) and when eligibility criteria and payment formulas were enacted. Because of these characteristics, entitlements undermine both short-term fiscal discipline and the long-term capacity of government to stabilize its financial condition. In the short run, it may be difficult for the government to accurately estimate the amounts to be spent or to buffer the budget from unanticipated (or unwanted) swings in economic conditions. In the long run, the budgets of many countries will be
exposed to the fiscal consequences of an aging population, especially in their pension and health sectors. Even when short-term fiscal policies are affordable, they may become unsustainable as the dependent population rises and entitlements take a larger share of the budget.

Entitlements suffer from a costly variant of the “common resource pool” problem that drives total public spending upward, in many cases to unsustainable levels. In the standard common pool situation, each “taker” acts alone or logrolls with others to draw resources from the pool. The takings are individualized; what one gets, others do not. In entitlements, however, the takings are mutual; one gets because others also get. All get even if they do not logroll or actively stake a claim to the pooled resources because entitlements confer broad rights to beneficiaries. These rights are not diminished by the government’s inability or unwillingness to pay, or by other claims on the budget. In the commons, when the pool is depleted, nobody takes because there is nothing left. In entitlement programs, however, beneficiaries continue to get, even when the government’s revenues have been depleted. When it runs out of money, the government makes good on the beneficiaries’ rights by borrowing or “printing” the needed funds.

The best time to control entitlements is before they have been established. Beyond this point, the government can exercise fiscal control only by taking away previously conferred benefits. This is in sharp contrast to the politically expedient function of the budget—to distribute benefits. Inasmuch as “taking from” is much more difficult than “giving to”, when a government entitles others, it inevitably weakens fiscal self-discipline.

Developing (and some transitional) countries generally have small entitlement budgets. But as they progress and economic conditions improve, these governments tend to follow the path taken by the developed world: they introduce or enhance pension schemes, improve citizen access to health care, provide financial assistance to the disabled and unemployed, and so on. Transitional countries may face pressure for broadened entitlements early in their embrace of market-oriented democracy, as they seek to cushion households against the economic hardships caused by the end of subsides, rising prices, and the privatization or closing of state enterprises.
Ideally, developing and transitional leaders should be cautious in taking on new fiscal burdens, because the entitlements established to ease the transition or in response to real improvement in economic well-being will draw scarce funds from the public treasury for many years to come.

During the past two decades, most industrial democracies have been reluctant to create or expand entitlements. They have been wary of adding entitlements because their national budgets have been strained by chronic deficits. A few have adopted formal rules that bar new entitlements that would add to the deficit. Since 1990, for example, the United States Government has enforced a pay-as-you-go rule that has made it difficult to expand entitlements. Under the rule, legislation that increases entitlement spending must be offset by cutbacks in other entitlements or by revenue increases. The rule is enforced through a multi-year expenditure baseline that provides Congress and the President timely information on the projected costs of new entitlements.

Most formal and informal efforts to constrain entitlements have come only recently, after the costly framework of existing entitlements already was inscribed in law. Although developed countries have had few success stories in disciplining their entitlement budgets, some have tried and an increasing number can be expected to make the effort in the years ahead. Efforts along these lines are likely, for if entitlements are not effectively controlled by the time that the financial implications of an aging population impacts national budgets, supposedly hard constraints on aggregate spending will turn out to be very soft.

Table 3.1 lists some of the approaches that may be taken by governments bent on strengthening fiscal discipline. They range from options which disentitle current or future beneficiaries to those which retain the basic structure of entitlements but save money by making marginal adjustments in payments or eligibility rules. Disentitling is the boldest approach, but politically the most difficult. It can be accomplished by terminating legal rights and making payments dependent on discretionary appropriations. Alternatively, the government can convert certain entitlements into private schemes, thereby reducing its fiscal liability. For example, some countries have been influenced by Chile’s social security reform to create a two-tier sys-
### Table 3.1: Controlling the Costs of Entitlements

<table>
<thead>
<tr>
<th>Method</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
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<tbody>
<tr>
<td><strong>Disentitlement.</strong></td>
<td>Spending would be subject to budget decisions, and would depend on government's ability to pay.</td>
<td>Would reduce government's role in stabilizing and redistributing income, and impair its ability to protect citizens against recession, aging, illness, and other adversities.</td>
</tr>
<tr>
<td><strong>Voluntary Opt-out.</strong></td>
<td>Market incentives would favor most efficient plans, while reducing financial risk to government.</td>
<td>Risk of adverse selection, with most vulnerable persons remaining in government programs. Government would have moral (or legal) obligation if private plans failed.</td>
</tr>
<tr>
<td><strong>Capped Entitlements.</strong></td>
<td>Entitlements would have to compete against other claims on the budget. Spending in excess of budgeted amount would not be automatic or open-ended.</td>
<td>Dependent populations would be adversely affected. Moreover, enforcing the caps might be impractical for political or technical reasons.</td>
</tr>
<tr>
<td><strong>Disindexation.</strong></td>
<td>Payment increases would not be automatic and could be made in the light of the Government's budget condition.</td>
<td>Real value of payments would be eroded by inflation, with greatest impact likely on low-income recipients.</td>
</tr>
<tr>
<td><strong>Targeted entitlements.</strong></td>
<td>Scarce resources would go to most need recipients, thereby reducing cost to government.</td>
<td>Public support for certain entitlements would be undermined, as would the concept of universal benefits.</td>
</tr>
<tr>
<td><strong>Tax benefits.</strong></td>
<td>Effect would be similar to targeting, but might be politically easier to implement.</td>
<td>Marginal tax rates would be very high for some recipients, discouraging them from income-earning activity.</td>
</tr>
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</table>
tem in which only a portion of pensions are financed through the public budget. One tier is a defined benefit plan in which the government guarantees a minimum payment to all participants; the other tier is a defined contribution plan in which the amount paid out depends on the performance of each participant's pension account. The shift from defined benefits to defined contributions also can occur within a wholly-public pension system.

While drastic restructuring of entitlements may be feasible in some countries, others are likely to settle for marginal reforms. One option is to trim entitlement spending by targeting payments to lower-income individuals or by reducing the real value of the benefits. Australia has taken the first path, limiting some transfer payments to low-income households; the Netherlands has taken the second path, reducing the percentage of wages replaced by unemployment benefits and other schemes. Still another approach is to trim entitlements indirectly, by taxing benefits as if they were ordinary income. This tactic has two advantages: it enables the government to retain universal benefits, which are (in some countries) a hallmark of the welfare state; and it means-tests the value of entitlements through the tax system.

In striving for aggregate fiscal discipline, some governments might limit the amount paid out each year. Entitlement programs would be cash-limited, just as running costs and other payments are in some countries. In enforcing the limits, the government might prescribe pro rata reductions in transfer payments or (in programs such as health care) in fees to providers. Alternatively, if the limit were breached, the government would be required to take an explicit decision to raise the limits or to make some other adjustments that would hold spending to the preset ceiling.

In imposing fiscal discipline on entitlement budgets, governments must be mindful of the risks entailed in weakening or disabling built-in stabilizers and in adverse impacts on dependent persons. As important as it is, fiscal discipline is not the only financial objective of governments. Many also seek to protect citizens made dependent by age, unemployment, or other economic circumstances, and they seek to counter the adverse effects of recessions and inflation. Doing these things entails income support and stabilization through entitlement programs.
### Table 3.2: Issues in Managing Financial Risks

**In All Countries**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>1. Moral Hazard</td>
<td>Persons/firms take undue risks when losses are compensated by the Government.</td>
</tr>
<tr>
<td>2. Lack of Transparency</td>
<td>In cash budgeting, the cost to Government is not accounted for until payment is made.</td>
</tr>
<tr>
<td>3. Lack of Information</td>
<td>Government usually does not know the extent of its contingent liabilities and other risks, the probability of the contingency occurring or the prospective cost.</td>
</tr>
<tr>
<td>4. Lack of Budgetary Control</td>
<td>Funds are allocated after the contingency has occurred, too late for the government to effectively control the amount it spends.</td>
</tr>
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</table>

**Developing/Transitional Countries**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. Underdeveloped Insurance Market</td>
<td>Government often assumes risk because the private insurance system is under-developed.</td>
</tr>
<tr>
<td>6. Efforts to Privatize Enterprises</td>
<td>To encourage investors (or to obtain a higher price) the Government may provide explicit or implicit guarantees to purchasers of state-owned enterprises.</td>
</tr>
<tr>
<td>7. Inadequate Regulation</td>
<td>During transition or development, there may be a tendency to under-regulate financial institutions (and other risk takers) either because of cozy relationships between politicians (or bureaucrats) and the institutions, or because of failure to appreciate the need for robust, arms-length regulation.</td>
</tr>
<tr>
<td>8. Risky Behavior</td>
<td>There may be a tendency for risky behavior during early stages of market development, encouraged by inadequate regulation and lack of instruments to assess and manage risk.</td>
</tr>
<tr>
<td>9. Concentrated Risk</td>
<td>Because markets are under-developed, risk may be concentrated in a small number of enterprises or risk takers, making it difficult for the government to assess or control the risks.</td>
</tr>
</tbody>
</table>
Although entitlements will continue to be the most prominent part of national budgets, it is highly probable that no later than the second decade of the next century, most developed countries will take significant measure to curtail transfer payments. Many of these efforts will be controversial; some will cause the downfall of governments; all will require strong political leadership.

Developing and transitional countries would do well to study the experiences of more economically advanced countries before they assume the enormous financial risks inherent in an entitlements culture. To a far greater extent than happened in the developed world, they have the opportunity to explore market-type instruments for protecting citizens against the risks of economic distress.

Contingent Fiscal Risks
The conventional tools of government budgeting have been designed to manage cash flows; they generally have not been applied to contingent liabilities and similar fiscal risks. With few exceptions, governments account for revenue when money is received and for outlays when money is paid. This form of budgetary accounting may suffice for operating expenditures as well as for most transfer payments and public investments; it is not adequate for transactions in which the government is obligated to make a future payment if certain contingencies occur. Cash-based budgeting fails to record the government’s contingent risk at the time it is incurred. It does account for any subsequent payments, but at this point it is too late for the government to effectively control the expenditures it must make in fulfillment of its contingent liability. In fact, when the government charges an origination fee for providing guarantees, the cash budget records this income as revenue, but it does not show the government’s potential exposure to future payments. Of course, if default (or some other contingency) were to occur the cash budget would account for any payments, but these amounts would be “uncontrollable” obligations. The government would not strengthen control of expenditure it is obligated to make in fulfillment of its contingent liability just by recording the amount paid in the budget. The appropriate time for constraining fiscal risks is when they are incurred; at that point, however, the government typically is unaware of the full cost of
the liabilities to which it is exposed. Matters are made worse by the practice of booking up-front origination fees as current revenue. This makes it appear that the government is profiting from taking the risks, when, in fact, it often incurs heavy losses.

Contingent liabilities come in

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<thead>
<tr>
<th>Method</th>
<th>Advantages/Disadvantages</th>
</tr>
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<tbody>
<tr>
<td>1. Government marketizes risk by selling state-owned enterprises, withdrawing guarantees from financial institutions and other entities, and refusing to indemnify losers in market transactions.</td>
<td>Formal exposure to risk is reduced, but government may still have moral obligation to indemnify private risk-takers, especially in developing and transitional countries where markets are fragile.</td>
</tr>
<tr>
<td>2. Government purchases re-insurance that covers all or a portion of its fiscal risk. In developing and transitional countries, reinsurance would likely be purchased from multinational insurers, not from domestic firms.</td>
<td>Reinsurance limits fiscal risk, and informs the government of the cost of the risk it is taking. But the cost of reinsurance is likely to be quite high, and the government may be unwilling or unable to finance it in the budget.</td>
</tr>
<tr>
<td>3. Government charges risk-based premiums which transfer the costs from taxpayers to risk-takers or beneficiaries. These charges may include origination fees or annual service charges.</td>
<td>These premiums would discourage some risk-takers from seeking government protection, but they may also reduce productive risk-taking needed to develop the economy.</td>
</tr>
<tr>
<td>4. Government insures last rather than first loss by having high deductibles that are risk-based or adjusted for different types of risk-takers (e.g. households, firms, types of firms, sectors, etc.).</td>
<td>Risk is shared by government and risk-takers. But government may be pressed to cover first loss, especially when failure to do so injures households or the economy.</td>
</tr>
<tr>
<td>5. Government budget includes estimated costs as an expenditure, in effect setting aside a reserve for future payments.</td>
<td>Cost of risk is transparent, but it may be difficult to make reliable estimates, especially in developing and transitional countries where experience with similar risks is limited.</td>
</tr>
<tr>
<td>6. Government records estimated risk on financial statements, such as the balance sheet or statement of contingent liabilities.</td>
<td>Government’s financial condition reflects contingent liabilities and other risks. But few countries (even developed ones) publish comprehensive financial statements.</td>
</tr>
</tbody>
</table>
many forms and just about every national government has them. Hana Polackova of the World Bank has mapped out different types of risks and the measures governments might take to control them. For the present discussion, the most relevant risks are contingent liabilities that require future payment if a certain event, such as default or natural disaster, occurs. Many contingent liabilities are explicitly recognized in law, contract or other formal commitment; others arise out of the “moral obligation” of the government to assist those who have suffered financial loss, or form the expectation that it will provide such assistance. Obviously, the government knows less about these informal risks than about explicit contingencies, yet the potential cost may be greater. In fact, the expectation that the government will act may escalate as the losses increase. For example, if a small bank fails, the government may opt to do nothing, but when a large bank fails, the government may be impelled to act in order to stabilize financial markets and restore public confidence.

The list of contingent liabilities is lengthy. It includes: indemnifying farmers against crop losses; homeowners against floods; exporters against exchange rate fluctuations; depositors against bank failures; entrepreneurs against losses; investors against default; and so on. Because of the inadequacies of cash accounting, the extent and magnitude of contingent commitments rarely are fully documented. In the United States, the General Accounting Office has estimated that by 1995, the federal government had accumulated $5 trillion in insurance commitments, an amount equal to three years budget outlays. With implicit guarantees and other types of contingent liabilities added in, the total might be considerably higher.

When government indemnifies losers, it spurs risk takers to behave in a morally hazardous manner by taking risks they would avoid if they had to bear the full cost of their actions. Moral hazard is widespread in government-insured programs: depositors seeking the higher yields offered by weak financial institutions; homeowners building in flood-prone areas; bankers lending to high-risk borrowers; exporters not hedging against currency rate fluctuations; and much more. The common element in moral hazard is that risk takers need be concerned only about the adequacy of the government’s commitment, not about
the riskiness of their actions. As a consequence, risks escalate, along with the cost to government.

Developing and transitional economies are especially prone to shifting risk to government. Table 3.2 itemizes some of the reasons why governments in these countries expose themselves to costly contingencies. One of the main reasons is that private insurance usually is unavailable or inadequate during the early stages of transition or development, leaving investors, entrepreneurs, lenders, and other with little recourse but to seek risk protection from government.

In many instances, the government is the insurer of last resort. If it fails to accept the risk, economic development would be retarded. Moreover, in privatizing state enterprises, the government may be impelled to guarantee minimum financial results, either to obtain a higher sales price or to enable the enterprise to continue as a going concern. The government’s exposure to risk may also increase because of the tendency during the early stages of development to under-regulate financial institutions; in transitional countries because the new democratic regimes have dismantled the regulatory systems imposed during communist rule and do not yet appreciate how sound regulation contributes to economic development; in less developed countries because weak or poor governments lack the will or resources to regulate powerful interests, or because cozy relationships with these interests deter them from doing so.

Contingent liabilities can best be managed when there are many risk takers, each of whom takes a small risk. The classic case is of homeowners who obtain mortgages insured by the government. Because there are many borrowers, the risk is pooled, government can charge each homeowner a risk-based premium, so that when some borrowers default, premium revenue covers all or part of the cost. In transitional and developing countries, however, risk tends to be concentrated: a small number of big risk-takers (financial institutions, conglomerates, etc.) take a very large part of the risk. When this occurs, it is hard to estimate the risk faced by government and harder yet to charge risk-based premiums. Matters are further complicated when cozy relations and deficient accounting practices spur financial institutions to extend credit to failing enterprises.

To maintain fiscal discipline, governments must control their contin-
Table 3.3 divides control mechanisms into those that rely on market decisions and those dependent on government action. Market-based solutions withdraw government from indemnifying losers or require risk-takers to pay the cost of government-provided insurance. Market solutions generally are favored in developed countries, for despite the extensive government exposure most economic risk is insured by private institutions. Although this approach might not yet be appropriate for developing or transitional countries that have inadequate private insurance systems, it would be sensible for governments in these countries to avoid policies that would retard the development of private insurance. As long as government is the insurer of first resort, the market for private insurance will remain underdeveloped, and risk-takers will behave in morally-hazardous ways that overburden government finance.

Another market-based solution would be for government to purchase reinsurance when it enters into a contingent commitment. A big advantage of this approach is that the total cost would be transparent, the government would not have to rely on estimates of future liability, nor would it have to wait until contingencies occur before paying the cost. Reinsurance would be priced by the market, and would be expensed at the time it was purchased. Up front costing would likely dampen the willingness of government to assume the risk, and might induce it to require risk-takers to share a portion of the cost. Another approach to sharing risk is to impose high deductibles on government-insured transactions.

Government-based remedies would have the government undertake contingent liabilities, but these would be itemized in the budget or in financial statements. Future costs would be estimated, using accounting principles devised for this purpose. This approach has been adopted by New Zealand which lists all quantifiable and non-quantifiable contingent liabilities in its consolidated financial statements. Notes to the statements estimate future pension liabilities, risk in managing debt and foreign currency, and certain other liabilities. The United States has taken a different approach. It expenses the net discounted cost of all estimated future cash flows (inflows and outflows) of each guaranteed loan program in the budget. Although the same methodology can be applied to other contingent lia-
abilities, thus far the U.S. Government has used it only for loan guarantees.

**Economic Cycles**

A government is most likely to be exposed to the costs of contingent liabilities when the economy is weak, financial institutions are in trouble, and its currency is losing value. During these periods, the government may have to prop up or take over insolvent banks, make good on exchange rate guarantees, assist failing enterprises, and take other actions that add significantly to public expenditure. This is not the most propitious time for contingent liabilities to come due, because it also is a period during which revenues are declining (or not growing as robustly as hoped for) and the budget deficit is rising.

Can a government maintain fiscal discipline under these adverse conditions? Judging from experience in developed countries over the past two decades, the answer is yes and no. Yes, in terms of discretionary fiscal stimulus; no, in terms of the impact of built-in stabilizers on key budget aggregates. Prior to the oil shocks and lower growth in the 1970s and early 1980s, many developed countries intervened to stimulate recovery by taking actions (tax cuts or spending increases) that enlarged the budget deficit. It was fashionable at the time to distinguish between cyclical and structural deficits, and to assume that cyclical imbalances would fade away once growth resumed and government revenues rose. Various fiscal measures were devised to distinguish between the two types of deficits and to calculate the appropriate size of the deficit.

Few developed countries actively manage the economy this way anymore. Most have found that the added costs (such as higher interest payments due to increased spending on public works or income support) approved when the economy is weak continue to burden the budget when the economy recovers. This concern has been heightened by lower growth rates during the past two decades than were experienced during the postwar boom years. Further, fiscal policy also has been influenced by changes in economic theory, such as the rational expectations argument that because government intervention during periods of weakness is expected, it fails to produce the intended effects.

But if discretionary action is out of style, built-in stabilizers still do their work. An automatic drop in revenue or
rise in transfer payments can produce large, unplanned deficits. A government can try to stay on its fiscal course by raising taxes or curtailing benefits, but it generally is inopportune to do so when the economy is stagnant. Countries that tighten fiscal discipline in these circumstances may unwittingly prolong and deepen the recession without achieving their budget targets. Japan may be a contemporary case in point. During a protracted slump, it ended temporary income tax relief, boosted consumption taxes, and curtailed supplemental public works programs. It acted in this manner because policy elites were more concerned about the long-run unsustainability of fiscal imbalances in the face of a rapidly aging population than about short-term economic distress.

Developing and transitional countries also face unstable budgets during economic difficulty. But they also risk capital flight, a run on their currency, illiquid financial institutions, and political instability. These countries may be compelled to adopt stringent budget policies as a condition of receiving international assistance or to restore investor confidence. To the extent they are dependent on capital inflows to stabilize or develop their economies, these countries may have to constrain public spending in the hope that fiscal discipline will be rewarded by long-term improvement in economic conditions.

Shocks
These disturbances are far more destabilizing than those caused by a cyclical downturn; they jar a government off its fiscal course and force structural changes in public policy. The primary cause might be the onset of war or the collapse of political order, but the budget is deeply affected. The unification of Germany began as a bold political decision, but has left a legacy of unplanned deficits and rising public debt. In developing countries, a severe drop in commodity prices or a sudden capital outflow can make it impossible for the government to abide by agreed fiscal policy. In transitional countries, the collapse or inefficient enterprises and difficulty in implementing a new tax system can have enormous impacts on the budget.

In dealing with shocks, as with cyclical downturns, it is important to distinguish between fiscal balance and fiscal discipline. Losing the former may be unavoidable; but the latter can be maintained even under stressful
conditions. Obviously, a government will be compelled to alter its fiscal targets when shocks register on its budget accounts. But this does not mean that fiscal discipline also is abandoned. It is when things seem to be falling apart that a disciplined approach to public spending may be most urgent. Constraining expenditures will not produce fiscal balance, nor will it enable the government to achieve pre-shock targets. But it will moderate and shorten the after effects of shocks on political or economic order.

Germany’s response to unification illustrates how fiscal discipline can be maintained in the face of severe budgetary shocks. To rebuild the Eastern sector, the government far exceeded expenditure plans, but it did raise taxes to finance a significant portion of the added cost and it did constrain other portions of the budget. Despite these moves, the government failed to achieve revised fiscal targets because it underestimated the cost of unification and faced a shortfall in economic performance. When shocks occur, it may be impossible to foresee the full cost at the outset or to make all appropriate adjustments in government policy. But the fact that Germany made the effort has left it in sturdier condition than if it had not tried.

**Summing Up: the Basic Elements of Aggregate Fiscal Discipline**

Maintaining aggregate fiscal discipline requires changes in budgetary institutions to establish and enforce spending constraints. The following are prominent elements of systems used in various countries.

- **TARGETS SHOULD REFLECT POLITICAL COMMITMENTS MADE BY POLITICAL LEADERS**

  Selecting the appropriate fiscal constraints is a key political responsibility of government. Developing appropriate targets must engage major political actors—the head of government, Cabinet, in some cases party leaders, and, (in coalition governments) an agreement among the governing parties. If politicians are not involved in agreeing the targets, they cannot be expected to take steps necessary to implement them. Even when the targets are externally imposed, as in the case of the European Monetary Union and IMF conditionalities, achieving them depends on political commitment and action in the affected country.
• **TARGETS MUST BE REALISTIC AND ACHIEVABLE**

If they are not, the targets will either be ignored or induce politicians to dissemble and conceal the true condition of the budget. In the mid-1980s, both the United States and Australia established aggregate fiscal targets, the former through a statutory limit on the size of the deficit, the latter through a trilogy policy that prescribed reductions in taxes, spending, and the deficit. The American targets were breached in every year (1986-90) that they were in effect; Australia, by contrast, had significant (though not lasting) success in constraining the aggregates. Australia’s targets were achievable, the American targets were not.

However, achievable, does not mean without constraint. Fiscal norms must be constrictive, for if they merely accommodate demands on the budget, there would be no gain in having them. Targets must discipline the fiscal aggregates, that is, they must result in lower deficits and less spending than would otherwise occur.

• **A MEDIUM-TERM FRAMEWORK FOR SETTING AND ENFORCING THE BUDGET AGGREGATES**

The medium-term is appropriate for several reasons. First, constraining total spending or the deficit typically requires implementing action over several years. A multi-year framework can establish milestones along the way toward full implementation. Second, it is easy to evade fiscal discipline when the targets pertain only to the current or the next financial year. Spending or revenue actions can be accelerated or delayed, depending on the year for which the budget outcome has to be made to seem more favorable than it actually is. Assets can be sold, new spending can be scheduled to take effect in the future, nonrecurring revenue sources can be exploited. Evasion also is possible in a medium-term framework, but the incentive and opportunity to manipulate the numbers is lessened.

The typical framework includes projections of future budget aggregates and the main subaggregates, a baseline that reflects authorized spending and revenue for the medium-term, procedures for estimating the fiscal impact of policy changes, accounting rules for enforcing fiscal discipline, and a process for establishing budget constraints. Developing and operating this medium-term framework becomes the major responsibility of the central budget office. As aggregate fiscal disci-
pline matures, annual budgets are formulated in the context of multi-year constraints. The annual budget becomes one year's installment in the multi-year fiscal strategy.

Even with a multi-year framework, governments periodically find it necessary to retarget fiscal policy. Doing so in a medium-term context enables them to assess the impacts of cyclical swings or policy shocks on the fiscal aggregates.

- **Aggregate norms should be supported by subtargets**
  
  Fiscal norms are not likely to hold in the face of spending pressures if only the totals are targeted. Ideally, spending constraints should extend to major subcomponents. These may include limits on running costs, discretionary spending limits, or limits on particular budget sectors, functions, or portfolios. When these sublimits are agreed, the aggregate constraints are sturdier because they reflect prior agreement on how total resources are to be parcelled out. The totals are not merely pie-in-the-sky numbers, but commitments on future spending plans.

  Yet it also is important that early agreement be confined to major subtotals. If decisions also were made on the various spending items, advance determination of the fiscal aggregates would be unduly influenced by particularistic claims on the budget.

- **The constraints should cover most key aggregates, not just total spending or the deficit**
  
  If only the deficit were targeted, aggregate discipline might be weakened by paying for spending increases with tax increases. If, however, only spending were constrained, politicians might cut taxes and allow the deficit to rise. The constraints do not have to cover all fiscal aggregates, but there may be considerable value in extending them to the public debt. A few countries have begun to constrain contingent liabilities, but most lack sufficient information to set effective limits on these fiscal risks.

- **Aggregate constraints should cover mandatory spending**
  
  Constraints that permit an open checkbook for entitlements or other mandated costs weaken aggregate fiscal discipline. Although it is unlikely that democratic governments will disentitle major benefit programs or disable the budget’s built-in cyclical stabilizers, it is highly probable
that they will act to trim entitlement spending at the margins, slow the spending growth in this area of the budget, and impose barriers to the establishment of new entitlements. As the fiscal burdens of demographic change draw nearer, more governments will be impelled to make hard choices about mandatory programs and to take politically unpopular actions. If they do not, aggregate fiscal discipline will resemble a poorly designed dam that cannot hold back the pent-up pressure building up against it.

• **Aggregate targets should include enforcement mechanism, including in-year monitoring and out-year projections.**

  Targets are not self-implementing; enforcement never is automatic. Effective constraints must include ongoing review during the year to assess whether the fiscal trends is in line with forecasts, as well as actions to be taken when the aggregates veer off target.

• **Hard constraints rarely are as hard as fiscal policymakers intend them to be.**

  The literature on aggregate fiscal discipline suggests that hard constraints are needed for controlling spending totals and the deficit. Hardness is a matter of degree, however. Absolute prohibition against breaching the totals may be too rigid to withstand political pressure or economic necessity. As aggregate fiscal discipline gains prominence as an objective of expenditure management, democratic governments may find supple arrangements which allow a safety valve for political and economic pressures more lasting and effective than unyielding targets. ☐