The core of public finances is that some people spend other people’s money. In democracies, voters delegate the power over public spending and taxes to elected politicians. Two aspects of this delegation arrangement are particularly important for the conduct of fiscal policy. The first is the principal-agent relationship between voters (the principals) and politicians (the agents). The second is the common pool problem of public finances (von Hagen and Harden 1995).

The delegation of power to elected politicians implies that politicians can extract rents from being in office and spend public moneys on projects other than those the voters desire. Voters might wish to limit these opportunities by subjecting politicians to strict and detailed rules that prescribe what they can and cannot do under specific circumstances. However, the uncertainty and complexity of the economic and political environment render the writing of such complete contracts impossible. Therefore, the principal-agent relationship resembles an “incomplete contract” (Persson, Roland, and Tabellini 1997; Seabright 1996), leaving politicians with considerable residual powers. The greater these residual powers are, the greater will be the divergence between voter preferences and actual policies.

The common pool problem of public finances arises from the fact that, in all modern democracies, politicians spend money drawn from a general tax fund on public policies targeted at individual
groups in society. As a result, the group of those who pay for specific policies (the general taxpayers) is typically larger than the group of those who benefit from these policies. The net benefits of such policies accruing to the targeted groups, therefore, typically exceed the net benefits for society as a whole, and the targeted groups and their political representatives usually demand more spending on such policies than what is optimal for society at large. Thus, the common pool problem leads to excessive levels of public spending. Putting the argument into a dynamic context, one can show that it also leads to excessive deficits and government debts (see, for example, Milesi-Ferretti 2004; Velasco 2000; von Hagen and Harden 1995).

This tendency toward excessive spending, deficits, and debt increases with the number of politicians who have access to the same general tax fund, a point empirically confirmed by Kontopoulos and Perotti (1999). In societies divided along ideological, ethnic, language, and religious lines, there can be an increased tendency of people in one group to neglect or ignore the tax burden falling on other groups, making the common pool problem more severe. Empirical studies showing that such schisms result in higher spending levels, deficits, and debt confirm the importance of the common pool problem (Alesina, Baqir, and Easterly 1997; Alesina and Perotti 1996; Annett 2000; Roubini and Sachs 1989).

The adverse consequences of the principal-agent problem and the common pool problem can be mitigated by appropriately designing the institutions that govern the decisions over public finances. This chapter focuses on the role of budgeting institutions and the scope for institutional design to achieve better fiscal outcomes. The analysis rests on the fundamental claim that institutions shape the outcome of the decision-making processes they govern. One may, of course, object that people always do what they want regardless of the rules under which they operate, or that institutions are themselves endogenous and are created to facilitate the outcomes the relevant actors wish to achieve. However, there is now a large amount of empirical evidence supporting our basic claim that institutions matter.1

The next section begins with a characterization of budgeting institutions. It then focuses on the principal-agent problem and how budgeting institutions can promote accountability of and competition among the political agents. The section that follows shows how budgeting institutions can address the common pool problem. The final section concludes.

**Budgeting Institutions**

The government budget is a record of the revenues and expenditures of a government during a given period of time. Ex ante, it shows what the
government intends to do during that period and how it intends to finance these activities. Ex post, it shows what the government actually did and who had to pay for it and in what form.

The budget itself is the result of the budgeting process, the way in which decisions about the use and funding of public resources are made, from the drafting of a budget law to its implementation. We define budgeting institutions generally as the collection of the formal and informal rules and principles governing the budgeting process within the executive and the legislature. Budgeting institutions divide the budgeting process into different steps, determine who does what and when in each step, and regulate the flow of information among the various actors. In doing so, such institutions distribute strategic influence and create or destroy opportunities for collusion and for holding individual agents accountable for their actions. The constitutional role of the budgeting process is to provide a framework in which all competing claims on public funds are manifested and reconciled with each other.

Budgeting processes can be proximately divided into four stages, each involving different actors with different roles. The executive planning stage involves the drafting of the budget by the executive. The legislative approval stage involves the passage of the budget law through the legislative process, including the process of parliamentary amendments to the budget proposal, which may involve more than one house of parliament. The executive implementation stage covers the fiscal year to which the budget law applies. The ex post accountability stage involves a review of the final budget documents by a court of auditors or a similar institution, checking the consistency of such documents with the legal authorization.

We distinguish three types of budgeting institutions:

1. Institutions shaping the environment of the budgeting process
2. Output-oriented rules

**Institutions Shaping the Environment of the Budgeting Process**

Unless it is comprehensive, the budgeting process cannot fulfill its constitutional role as the framework within which all claims on public finances compete with each other. That is, no claims on public funds must be allowed to be made outside the framework of the budgeting process or the budgeting process will not be able to control the principal-agent and the common pool problems of public finance. Comprehensiveness is, therefore, an important requirement of the budgeting process. There are four important deviations from comprehensiveness.
The first deviation is the use of off-budget funds to finance government activities. Off-budget funds allow policy makers to circumvent the constraints of the budgeting process and to shield their decisions against the challenges of conflicting distributional interests.

The second deviation is the spreading of nondecisions; these occur when expenditures included in the budget are determined by developments exogenous to the budgeting process. Prime examples are the indexation of spending programs to macroeconomic variables such as the price level or aggregate nominal income, and open-ended spending appropriations, such as the government wage bill and welfare payments based on entitlements with legally fixed parameters. Nondecisions conveniently allow policy makers to avoid tough decisions (Weaver 1986), but they degrade the budgeting process to a mere forecast of exogenous developments.

The third deviation is the lack of sufficient distinction between (a) non-financial laws that create the legal basis for the public policies pursued by the government and (b) financial laws—the budget—that authorize annual government expenditures for these policies. In most modern democracies, legislative processes differ for financial and nonfinancial laws. Where this is not the case, mandatory spending laws—nonfinancial laws that make certain government expenditures compulsory during the fiscal year—may exist. The budget then becomes a mere summary of existing spending mandates created by simple legislation. Even where legislative rules distinguish between financial and nonfinancial laws, politicians may be allowed to attach riders to non-financial laws that require the government to spend funds on certain projects. The use of such riders, which was pervasive in the U.S. Congress until the 1980s, facilitates logrolls constructed to ensure that there is “something for everyone” in a legislative proposal. An effective budgeting process requires that riders with financial implications be prohibited.

The fourth deviation occurs when the government enters into contingent liabilities such as guarantees for the liabilities of other public or nonpublic entities. Promises, implicit or explicit, to bail out subnational governments (as in Germany in the late 1980s), regional development banks (as frequently in the past in Brazil), financial institutions (as in the savings and loans debacle of the 1980s in the United States), or large corporations (as in the fiscal crisis in the Republic of Korea in the late 1990s) can suddenly turn into large government expenditures outside the ordinary budget. In practice, contingent liabilities cannot be fully avoided, because government by its very nature provides a social insurance function, and a proper accounting of such liabilities is a difficult task. Still, the existence of such liabilities and their importance for the government’s financial stance can be brought to the
attention of decision makers in the budgeting process by requiring the government, as part of the budget documentation, to submit a report on the financial guarantees it has entered into.

A second, important requirement of the environment of the budgeting process is transparency. According to Kopits and Craig (1998: 1), transparency of the budgeting process “involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities . . . so that the electorate and financial markets can accurately assess the government’s financial position and the true costs and benefits of government activities.” Poterba and von Hagen (1999) argue that the inclusion of special accounts and the failure to consolidate all fiscal activity into a bottom-line measure reduce transparency. Alesina and Perotti (1996) include the use of optimistic forecasts on economic developments and the effects of new policies and creative accounting among the factors reducing transparency. The availability of links between the budgetary figures and national accounts is another prerequisite of transparency. The budget should not allow policy makers to hide expenditures or to use them for purposes other than those stated in the executive’s budget proposal and authorized by the legislature.

Aiming at the control of political agents, transparency requires that the budget be organized according to administrative functions and responsibilities. Program-oriented budgeting, which aims at identifying a government’s policies across administrative functions, is useful, but it should not replace budgeting according to administrative functions, because program-oriented budgeting tends to obscure political responsibilities. Procedural transparency is also required. Budgeting processes should be transparent in the sense that all actors know what they and others are expected to do, and when and how. Opaque processes for bargaining and conflict resolution promote logrolling and reciprocity and obscure the responsibilities of the actors involved. Alt and Dreyer-Lassen (2006) point out four dimensions of procedural transparency. The first is the number of separate documents in which a given amount of information is processed; the larger this number, the lower the degree of transparency. The second is the possibility for outsiders independently to verify the data and assumptions given in the budget. The third is a commitment to avoid use of opaque and arbitrary language and to apply generally accepted accounting standards. The fourth is the provision of explicit justifications of the data and explanations of the assumptions underlying the budget.2

A third, important requirement of the budgeting process is the achievement of an appropriate balance between the legal function of the budget and
its function as a management instrument. The legal function emphasizes the conformity of all expenditures with formal rules and legal criteria. Pursued to the extreme, it leads to perfect legalistic control of government spending, yet without asking whether the implementation of the budget meets the political and economic goals of government policy. Where this occurs, as, for example, in Italy until the 1990s or in Poland today, the ministry executing the legal control, which is usually the treasury, typically regards itself as very powerful in budgetary matters, but this power is limited to purely formal aspects of the budget.

As a management instrument, the budget can be regarded as a plan stating how the government intends to meet its policy goals given the expected economic developments during the relevant fiscal year. As new information arises during the fiscal year, meeting these goals efficiently may require reactions and some flexibility in the execution of the budget. A budgeting process overemphasizing the legality of government spending fails to account for this need. During the planning stage, overly legalistic budgeting processes tend not to ask whether the expenditures demanded by the spending branches of the executive are adequate to fulfill the policy goals. During the implementation stage, such budgeting processes tend not to ask whether the expenditures authorized by the budget act are still adequate and make little room for adjustments.

At the same time, ex post accountability must be preserved; therefore, the legal role of the budget must not be neglected entirely. One way to strike a balance between the two functions is to put less emphasis on the legality of each expenditure and more on the legality of the decision-making processes under which these expenditures are made—that is, on ensuring that budgeting decisions are made by the proper actors following the proper procedures. Such a shift in emphasis allows for more flexibility in the execution of the budget while ensuring that this flexibility is used in conformity with the government’s policy goals.

**Output-Oriented Rules**

Output-oriented rules are ex ante numerical rules focusing on certain parameters of the budget. The most prominent ones are balanced-budget constraints of the kind prevailing today in almost all U.S. states and many provinces of Argentina and Canada. There is a fair degree of variation in these rules. Balancing the budget typically applies to the current expenditure budget; that is, borrowing for capital expenditures is not forbidden. Some rules oblige the executive branch of the government to present a balanced-budget proposal to
the legislature, and perhaps the legislature to pass a balanced budget, but allow government borrowing ex post. Others require the government to cover any deficits occurring ex post with surpluses during the following year. In some states, special referenda are required to authorize government borrowing. In the European Union (EU), member states must keep their annual government budget deficits below 3 percent of gross domestic product (GDP) and their government debt below 60 percent of GDP. Germany, Italy, Japan, and the Netherlands introduced rules requiring balanced current budgets after World War II to enhance the credibility of their macroeconomic stabilization programs. Since the late 1990s, the U.K. government must achieve balance on its current budget on average over the business cycle. The U.S. Congress adopted a fiscal rule in the Balanced Budget and Emergency Deficit Control Act (Gramm-Rudman-Hollings Act I) of 1985, which established numerical targets for the federal budget deficit for every fiscal year through 1991. In Switzerland, a constitutional amendment was passed in 1998 requiring the federal government to balance the budget by 2001 and to set annual ceilings for federal government expenditures afterward. The Convergence, Stability, Growth, and Solidarity Pact adopted by the member countries of the West African Economic and Monetary Union also contains numerical limits for certain fiscal aggregates.4

The advantage of output-oriented rules is that they are very specific: they spell out exactly what a government can do. But this specificity is also a drawback, because it implies a lack of flexibility in the reaction of fiscal policy to unforeseen events. The question of whether balanced-budget rules keep U.S. states from responding efficiently to revenue and expenditure shocks has been the subject of considerable debate (see, for example, Canova and Pappa 2005; Fatás and Mihov 2003). Similarly, the political debate over the fiscal rules in the European Monetary Union focused largely on the question to what extent these rules keep governments from smoothing taxes and expenditures over the business cycle. Output-oriented rules forcing governments to refrain from macroeconomic stabilization and tax smoothing may thus have a cost in terms of the efficiency of fiscal policies. The experience of the European Monetary Union suggests that governments will tend to ignore or circumvent the rules if they perceive this cost to be very large. Thus, very stringent output-oriented rules may lack credibility precisely because they are so strict. Credibility requires some flexibility for reacting to unexpected developments. Too much flexibility obviously implies that the rules no longer control the political agents’ performance effectively. Thus, output-oriented rules imply a tradeoff between effectiveness and credibility.
One way to address this tradeoff is to condition output-oriented rules on the state of the business cycle. For example, the need to balance the budget might be stated in terms of the cyclically adjusted budget deficit rather than the actual deficit, or a deficit or spending limit might be stated as a ratio of potential GDP rather than actual GDP. Both of these measures would require smaller deficits and spending during cyclical upswings but would allow larger deficits and spending during cyclical downswings; they would work as automatic stabilizers built into the tax and transfer system. In practice, however, this approach is difficult because the cyclical component of GDP and government spending and revenues is not easily determined in real time, when fiscal policy decisions have to be made.5

The attractiveness of output-oriented rules as a means to control the behavior of political agents stems from the apparent simplicity of a rules-based framework. Once the rule is in place, it seems straightforward to measure the government’s performance against it. Historically, in fact, voters often imposed such rules in response to episodes of fiscal crisis and rising taxes that they believed were the result of the profligacy of their political representatives (see, for example, Eichengreen and von Hagen 1996). Empirical evidence, however, suggests that the effectiveness of output-oriented rules is rather questionable. For example, U.S. state governments subject to stringent numerical debt limits tend to borrow using debt instruments not covered by the legal rule, with no significant effect on total debt (Strauch 1998; von Hagen 1991). Kiewiet and Szakaly (1996) find that state governments subject to more restrictive borrowing constraints tend to substitute municipal debts for state debt. Fatás and others (2003) find that the deficit limits of the European Monetary Union did not constrain deficits effectively in the large member states. Also, von Hagen and Wolff (2006) show that member states of the European Monetary Union use creative accounting to circumvent the deficit limits. In U.S. states, constitutional expenditure limits tend to induce a shift from the (constrained) current budget to the (unconstrained) investment budget (Strauch 1998). Rueben (1997) and Shadbegian (1996) find in cross-section studies of U.S. states that tax and expenditure limits have no significant effect on the level of spending. The key insight from this research is that the effectiveness of output-oriented rules is limited at best, because the rules can be circumvented.

Procedural Rules

Procedural rules define the processes under which budgeting decisions are made. In practice, there are two types: rules that focus on decision makers and rules that focus on content. Rules focusing on decision makers define
the authorities of the actors involved in the budgeting process. At the executive planning stage, such rules determine the role and power of the finance minister and the spending ministers and set forth the rules of conflict resolution among them. At the legislative stage, procedural rules determine the agenda-setting power of the executive vis-à-vis the legislature, the scope for parliamentary amendments, and the legislature’s information rights. At the implementation stage, they determine the finance minister’s power to manage the execution of the budget and to enforce the budget law, and they define the limits for deviations from the original budget law.

Procedural rules focusing on content determine the calendar of the budgeting process and emphasize the role of numerical targets. As discussed below, numerical targets for budgetary aggregates such as the annual deficit, total spending, and overall allocations for the individual spending ministries can be a commitment device for fiscal discipline. For example, since the mid-1980s, the Danish budgeting process begins with an agreement on the total allocations for all spending ministries negotiated among the members of the executive. Such rules may also require the government to embed the budget for any given fiscal year in multiannual fiscal programs highlighting the consistency of government policies over time. A prime example is the Stability and Growth Program that each member state of the European Monetary Union is required to submit annually to the European Commission. These programs state the budget for the following year together with the budgetary plans for the following three years.

At the implementation stage, content-related procedural rules are often backed up by precise prescriptions for dealing with unexpected revenue and expenditure shocks. An example is Belgium’s “Golden Hamster,” the rule that any unexpected surpluses in the budget arising from unexpected revenues or unexpectedly low expenditures must be spent to pay down the national debt.

**Budgeting Institutions and the Principal-Agent Problem**

In this section, we show how the principal-agent problem of public finances can be addressed by political institutions.

**Controlling Agents through Accountability and Competition**

In a democracy, the main instrument for dealing with the principal-agent relationship between voters and elected politicians is the election. According to the retrospective-voting paradigm, voters use elections to hold politicians accountable for past performance (Persson and Tabellini, 2000). They reappoint incumbents if they find their behavior satisfactory; otherwise, they vote
for competing candidates. This paradigm suggests that rents can be limited by strict accountability and fierce competition. Research in this area has examined the effect of electoral institutions on public finances and shown that they affect both the size and the structure of public spending as well as the size of the deficit and the level of public debt.6

Electoral institutions are characterized by district magnitude, electoral formula, and ballot structure. District magnitude relates to the number of representatives elected from each electoral district. Electoral formula translates votes into seats. Ballot structure determines how citizens vote, such as whether they cast votes for individual candidates or whether they vote for entire party lists. Small district magnitude, plurality rule, and votes cast for individual candidates focus elections on the personal performance of the candidates and allow voters to hold them personally accountable. Large district magnitude, proportional representation, and votes cast for fixed party lists focus elections on the average performance of all candidates on the party list and weaken personal accountability. The smaller districts, pluralities, and districts with individual candidates more effectively limit the scope for extracting political rents from being in office.

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

Furthermore, Skilling and Zeckhauser (2002) argue that voters inherently favor smaller over larger levels of public debt, and the more so, the larger the level of debt to begin with. The more competitive an electoral system, the better the voters can discipline governments by voting them out of office if they run undesirably large deficits. Skilling and Zeckhauser’s empirical work confirms that the competitiveness of electoral systems reduces deficits and public spending.

Budgeting Institutions, Accountability, and Competition

Budgeting institutions can strengthen the accountability of political agents and the competitiveness of the political system and thus contribute to
controlling the principal-agent problem of public finances. Comprehensiveness of the budget is important in this regard. If government expenditures can be hidden in off-budget funds and shielded from democratic control, voters are unable to hold the government accountable for its performance.

Political accountability can also be weakened by nondecisions, as described above. The more automatic adjustments a budget contains and the more appropriations are driven ex post by private sector demands for entitlements, the less a government can be made responsible for budgetary outcomes. A similar point relates to the tension between the use of the budget as a legal instrument and its use as a management tool. Emphasizing the use of the budget for making decisions on and implementing political strategies and developing medium-term economic plans creates opportunities for voters to compare the government’s performance with its past intentions. The result is greater political accountability. In contrast, if budgeting is perceived as a mere legal exercise, it may facilitate accountability in a legal sense, but not in a political sense.

Transparency of the budgeting process is another important element of political accountability. Transparency enables voters to understand a government’s fiscal plans. The ability to compare the actual performance of the government against its past plans and intentions is an essential condition of the retrospective voting paradigm. Focusing budgets and budget negotiations on numerical targets for the main budgetary parameters creates natural yardsticks by which voters can assess the actual performance of a government. Similarly, the ability to understand the political bargaining process around the budget and to check whether individual policy makers kept the commitments they entered into during this process is an important condition for holding policy makers personally accountable in elections.

Thus, the institutions shaping the environment of the budgeting process can be designed to promote fiscal discipline by strengthening the accountability of political agents to their political principals, the voters.

Budgeting institutions can also be designed to increase the competitiveness of the political system. Incumbent governments naturally have a competitive advantage resulting from the fact that they have more data available to develop their electoral platforms. At the same time, parties challenging the incumbent government can make lots of promises that are based on incomplete information about the actual state of the government’s finances. In both cases, it is consequently difficult for voters to judge between the incumbent and the challengers. Here, the Netherlands offers an interesting example of institutional design. The Dutch Central Planning Bureau is an independent economic research institute that is charged with presenting an assessment of the government’s annual budget proposal. In Dutch
elections, opposition parties present their economic and fiscal programs to
the Central Planning Bureau, which publishes an evaluation of the economic
and fiscal consequences of the programs. This puts the incumbent and the
challengers on more equal grounds in the electoral competition.

Other countries in Europe use similar arrangements to improve and
guarantee the objectivity of the economic forecasts and assumptions under-
lying the budget (Hallerberg, Strauch, and von Hagen 2001). Generally,
transparency of the budget and publicly available fiscal data will reduce
incumbent advantages and increase political competition.

**Budgeting Institutions and the Common Pool Problem**

At the heart of the common pool problem of public finances is an externality
that results from using general tax funds to finance targeted public policies.
Individual politicians perceive that an increase in spending on targeted policies
will provide their constituencies with more public services at only a fraction
of the total cost. The resulting spending and deficit biases can be reduced by
inducing politicians to take a comprehensive view of the costs and benefits
of their decisions. A *centralized* budgeting process contains elements that
induce decision makers to internalize the common pool externality by tak-
ing a comprehensive view of their decisions. A *fragmented* budgeting process
fails to do so.7

At the executive planning stage of the budgeting process, the purpose of
institutional rules of centralization is to promote agreement on budget
guidelines (spending and deficit targets) among all actors involved, thereby
ensuring fiscal discipline. The rules of centralization at this stage must foster
consistent setting of such guidelines and ensure that they constrain executive
decisions effectively. A key issue concerns the way conflicts are resolved.
Uncoordinated and ad hoc conflict resolution involving many actors simul-
taneously promotes logrolling and reciprocity and, hence, fragmentation.

At the legislative approval stage, rules of centralization should control the
debate and voting procedures in the legislature. Because of the much greater
number of decision makers involved, the common pool problem is even
larger in the legislature than in the executive. Fragmentation spreads when
there are no limits to the changes that parliament can make to the executive’s
budget proposal, when spending decisions are made in legislative committees
with narrow and dispersed authorities (the “Balkanization of committees”—
see Crain and Miller 1990), and when there is little guidance of the parlia-
mentary process either by the executive or by the speaker of the legislature.
Centralization comes with strengthening the executive’s agenda-setting
power by placing limits on the scope of amendments, controlling the voting procedure, and raising the political stakes of a rejection of the executive’s budget, such as by making it equivalent to a vote of no confidence. Centralization can also come with strengthening the roles of the speaker and the financial committee in the legislature.

At the implementation stage, rules of centralization ensure that the budget law effectively constrains the spending decisions of the executive. One important element is the finance minister’s ability to monitor and control spending flows during the fiscal year. Another important element is the limitation of changes to the budget law during the year.

**Delegation and Contracts**

Empirical studies of the budgeting process in member countries of the Organisation for Economic Co-operation and Development and developing countries show that there are two basic approaches to centralization of the budgeting process: delegation and contracts. Delegation vests special authority in a “fiscal entrepreneur,” whose functions are to set the broad parameters of the budget and to ensure that all other participants in the process observe these constraints. To be effective, this entrepreneur must have the ability to monitor the other members of the executive and to use selective punishments against possible defectors. Among the cabinet members, the entrepreneur is usually the finance minister, who is typically perceived as being less bound by individual spending interests. Under the contracts approach, the budgeting process starts with an agreement among the main actors on a set of binding fiscal targets—that is, a fiscal contract. For this approach to be effective, there must be a significant punishment for breaching the contract at the later stages of the process.

**Delegation**

In practice, delegation can take a variety of forms. In the French model, the finance minister and the prime minister together determine the overall allocations of the spending departments. These limits are considered binding for the rest of the process. Here, the finance minister has a strong role as agenda setter in the budgeting process. The U.K. model, in contrast, evolves as a series of bilateral negotiations between the spending departments and the finance minister, who derives bargaining power from superior information, seniority, and political backup from the prime minister. In the German model, the finance minister has weak agenda-setting power but strong veto power in the cabinet, as his objection against the budget bids of
a spending ministry can be overruled only by a cabinet majority including the chancellor.

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

At the legislative stage, the delegation approach gives large agenda-setting powers to the executive over parliament. One important instrument here is a limit on the scope of amendments parliamentarians can make to the executive’s budget proposal. In France, for example, amendments cannot be proposed unless they reduce expenditures or create a new source of public revenues. In the United Kingdom, amendments that propose new charges on public revenues require the consent of the executive. Such restraints result in the budget constraint being felt more powerfully.

Another form of delegation operates through the voting procedure. The French government, for example, can force the legislature to vote in a block on large parts of or the entire budget, with only those amendments considered that the executive is willing to accept. In the United Kingdom, the executive can make the vote on the budget a vote of confidence, considerably raising the stakes for a rejection. A final element concerns the budgetary authority of the upper house. Where both houses have equal budgetary authority, as in Italy or Belgium, finding a compromise is a necessary part of the budgeting process. The effect tends to weaken the position of the executive because it now faces two opponent bodies. The executive may be strengthened by limiting the budgetary authority of the upper house, as in France and Germany, where the lower house prevails if an agreement between the two chambers cannot be reached. In the United Kingdom, the upper house has no budgetary authority at all, leaving the executive with only one chamber to deal with. The position of the executive can also be strengthened by giving the finance minister veto power over the budget passed by the legislature, as in Germany and Spain.

A popular argument holds that low transparency can improve the executive’s agenda-setting power over an otherwise strong legislature. In a number of African countries, for example, finance ministers systematically withhold information about government revenues and the cost of public policies from the members of parliament in an effort to prevent parliament from enacting budget bills with excessive spending and deficits. Such a practice would suggest that there is a tradeoff between centralization and
transparency of the budgeting process. This argument is a fallacy because it fails to recognize where the bias for excessive spending and deficits comes from. Hiding important information from the legislature shifts the relevant decisions outside the budgeting process. The result is that spending and deficits are still excessive. The better solution is to strengthen the agenda-setting powers of the executive, perhaps in a trade against more monitoring and ex post control powers of the legislature. Where such a trade is politically difficult, the budgeting process can be improved by forcing the legislature to vote on a bill setting the main parameters of the budget at a very early stage of the budgeting process, as, for example, in Italy today.

At the implementation stage, centralization requires that the finance minister be able to monitor and control the flow of expenditures during the year. At this stage, in particular, the budgeting process should emphasize the role of the finance ministry as a manager of the government’s financial resources rather than as a mere controller of the legality of public spending. A necessary condition is the existence of a unified system of government accounts through which the finance minister can manage cash flows during the year. Spending departments should be required to obtain the finance minister’s authorization to disburse funds. The finance minister’s authority to impose cash limits during the year is another control mechanism. Effective monitoring and control are also important to prevent spending departments from behaving strategically—that is, from spending their appropriations early in the year and demanding additional funds later under the threat of closing down important public services.

Furthermore, centralization requires tight limits on any changes in the original budget law through the modification of appropriations once the fiscal year has begun. One example is the requirement that transfers of funds between different chapters of the budget be authorized by the finance minister or parliament. The same applies to transfers of funds between different fiscal years. “Rainy day funds”—unspecified appropriations under the control of the finance ministry that can be used to cover unexpected revenue shortfalls or spending increases—can be used to give the finance minister more flexibility for managing the budget during the implementation stage. An example is the contingency reserve included annually in the U.K. budget. The purpose of the reserve, which amounts to 2 to 4 percent of the budget total, is to deal with unanticipated expenditures without overrunning the aggregate targets imposed on the spending departments. According to a rule introduced in 1976, a refusal by the finance minister to charge expenditures against the reserve can be overruled only by the entire cabinet.
An allocation made from the reserve does not increase a spending department's baseline allocation for the subsequent budget planning processes.

Finally, the use of supplementary budgets should be very restrictive. Where supplementary budgets during the fiscal year become the norm, as in Belgium and Italy in the 1980s and Germany and Japan in the 1990s, one cannot expect that policy makers will take the constraints embedded in the original budget law seriously.

**Contracts**

Under the contracts approach, the budgeting process starts with an agreement on a set of binding fiscal targets negotiated among the members of the executive. Emphasis here is on the bargaining process as a mechanism to reveal the externalities involved in budget decisions and on the binding nature of the targets. In contrast to the hierarchical structure created by delegation, the contracts approach relies on a more equal distribution of strategic powers in the executive. A prime example is the Danish budgeting process, which, since 1982, has started with negotiations among the cabinet members to fix spending limits for each spending department. Often, these spending limits are derived from medium-term fiscal programs or the coalition agreement among the ruling parties. For example, Irish coalition agreements since 1989 have regularly included medium-term fiscal strategies to reduce the public debt, and these strategies have provided the background to the annual negotiations over budget targets. Furthermore, the negotiations leading to the fiscal targets often include the leaders of the parties supporting the government in the legislature, in addition to the members of the executive.

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

At the legislative stage, the contracts approach places less weight on the executive's role as an agenda setter and more weight on the role of the legislature as a monitor of the faithful implementation of the fiscal targets. Institutionally, this means that the contracts approach relies less on the executive branch of government controlling parliamentary amendments and more on the legislature's ability to monitor the fiscal performance of the executive. This ability depends on the legislature's right to request information from the executive. It can be strengthened by setting up committees with the same authorities as the spending departments, with the formal right to request
information from the executive and to call witnesses from the executive to testify. The Danish parliament, for example, has all three of these rights, whereas the German parliament has only the first, and the U.K. parliament has none of the three.

At the implementation stage, the contracts approach resembles the delegation approach in emphasizing the monitoring and control powers of the finance minister. However, the contracts approach achieves flexibility to react to unforeseen budgetary developments less by giving the finance minister managerial discretion and more by setting up contingent rules for dealing with such events. For example, the Swedish government adopted a budgeting process in the early 1990s that allows spending departments to charge expenditures against future budgets or to transfer unused appropriations to the next year. Transfers are possible, however, for only a limited number of years. Because the charges and transfers must be budgeted in the following year, the provision combines flexibility with transparency and gives both the legislature and the finance minister the ability to control the flow of expenditures.

Esfahani (2000) reports that finance ministries in developing countries often have the authority to slash expenditures during the implementation stage in order to keep spending in line with revenues. Such authority is regarded as an effective way of dealing with revenue shortfalls and expenditure shocks. Such a strong position of the finance minister could be consistent with both the delegation and the contracts approach. Importantly, however, a strong position of the finance minister in the implementation stage must not be seen as a way to correct institutional weaknesses—and the resulting bias toward excessive spending and deficits—at the earlier stages of the budgeting process. The spending ministries and the members of parliament would anticipate the finance ministry’s behavior at the implementation stage and use overly optimistic revenue forecasts and unrealistically high cost estimates to increase their spending allocations ex ante. The result would be low transparency and effectiveness of the budgeting process. Furthermore, the finance ministry would not necessarily set the priorities in slashing expenditures in line with the government’s political and economic goals. An effective budgeting process requires strong centralization based on either delegation or contracts at all stages.

A rich body of empirical research exists today showing that centralization of the budget process promotes fiscal discipline. This research has analyzed the link between budgeting institutions and fiscal performance in EU countries, European transition economies, Japan and other Asian countries, and Latin American countries, as well as subnational governments in Argentina and the United States.⁸
Delegation, Contracts, and Electoral Systems

The delegation approach relies on hierarchical structures within the executive and between the executive and the legislature. In contrast, the contracts approach builds on a more even distribution of authorities in government. In democratic settings, hierarchical structures typically prevail within political parties, while relations between parties are more even. This difference suggests that the key to the institutional choice between the two approaches lies in the number of parties in government.

Parliamentary systems

In parliamentary systems, delegation is the proper approach to centralization for single-party governments, whereas contracts are the proper approach for multiparty coalition governments (Hallerberg and von Hagen 1998, 1999). There are two reasons for this statement.

First, members of the same political party are more likely to have similar political views regarding the basic spending priorities than are members of different political parties. Spending ministers in a one-party government can, therefore, be fairly sure that the finance minister holds more or less the same spending preferences they do. Disagreement will be mainly a result of the common pool problem—that is, the perceived cost of distributive policies. In a coalition government, in contrast, cabinet members are likely to have more diverging views regarding the distribution of government spending over different groups of recipients. Agreement on a budget, therefore, involves a compromise between the coalition partners. For a coalition government, delegation of strategic powers to the finance minister would create a new principal-agent problem. A strong finance minister might abuse his or her powers and unduly promote the political interests of his or her own party. The same principal-agent problem does not arise in the contracts approach, because the contracts are negotiated by all cabinet members. Thus, governments formed by two or more parties are more likely to opt for the contracts approach.

Second, delegation and contracts rely on different enforcement mechanisms for the budget agreement. In one-party governments, the ultimate punishment for a spending minister reneging on the budget agreement is dismissal from office. Such punishment is heavy for the individual minister who overspends but generally light for the government as a whole. It can be used because the prime minister is typically the strongest cabinet member in one-party governments and has the authority to select and replace cabinet members. In coalition governments, in contrast, punishments cannot be
applied easily to defecting ministers. The coalition agreement sets the
distribution of portfolios. Therefore, the prime minister cannot easily dismiss
intransigent spending ministers from parties other than his or her own,
because that would be regarded as an intrusion into the internal party affairs
of coalition partners.

The most important punishment mechanism in coalition governments
is the threat of breaking up the coalition if a spending minister reneges
on the budget agreement. This punishment is heavy for the entire coali-
tion, because it leads potentially to the death of the government rather
than the dismissal of a single individual. The point is illustrated by the
fact that fiscal targets are often part of the coalition agreement. The cred-
ibility of this enforcement mechanism hinges on two important factors.
The first is the existence of alternative coalition partners. If other poten-
tial partners exist with whom the aggrieved party can form a coalition, the
threat to leave the coalition is clearly more credible than if no alternative
coalition partner is available. The second factor is the expected response
of the voters, because a coalition may be broken up with the anticipation
of new elections.

The different enforcement mechanisms also explain the different rela-
tions between the executive and the legislature in the legislative phase of
the budgeting process. Single-party governments typically arise in two-
party settings such as pre-1994 New Zealand, the United Kingdom, or the
United States, where each party is large and party discipline is low.
Although the ruling party enjoys a majority, the main concern in the
legislative stage of the budgeting process is to limit the scope of defections
from the budget proposals by individual members who wish to divert gov-
ernment funds to their electoral districts. Multiparty coalitions, in contrast,
typically arise in settings where parties are small and relatively homoge-
neous and party discipline is strong. In that situation, defections from
the budget agreement are a weaker concern, but each party involved in the
coalition will want to watch carefully to be sure that the executive sticks to
the coalition agreement. The delegation approach, therefore, typically
makes the executive a much stronger agenda setter in parliament than the
contracts approach, whereas the contracts approach gives more monitor-
ing powers to the legislature.

Finally, the commitment to fiscal targets embedded in the contracts
approach is not credible for one-party governments. Consider a single-party
government with a weak prime minister and a weak finance minister.
Assume that this government announced a set of fiscal targets at the outset
of the budgeting process and that some spending ministers renege on the
agreement during the implementation phase. Other cabinet members cannot credibly threaten the defectors with dissolving the government because they would punish themselves. Absent a credible threat, the entire cabinet would just walk away from the initial agreement.

In summary, the contracts approach is more likely to be found in countries where coalition governments are the norm, and the delegation approach is more likely to be found in countries where the government is typically formed by a single party.

**Presidential systems**

Presidential systems of government differ from parliamentary systems in that presidents do not rely directly on the legislature for their position as leader of the executive. Voters can—and often do—support a president from one party while denying that party a majority in the legislature. In Latin American and Caribbean countries from 1990 to 1995, half of the 20 countries with presidential systems had presidents facing opposition-controlled lower houses (Stein, Grisanti, and Talvi 1999). Coordination of budgetary decisions between the executive and legislative branches becomes obviously more difficult when the president and the majority come from two different parties.

The role of the executive in the budgeting process is not much different in presidential systems than in parliamentary ones. The president typically appoints the members of the administration, with confirmation by the legislature where applicable. The structure of the administration thus lends itself more to a delegation approach than to a contracts approach in centralizing the budgeting process. The relationship between the executive and the legislature, however, is often more difficult, because the two are conceived to be more equal than in parliamentary governments.

Centralization in presidential systems then must emphasize two institutional dimensions. One is the internal organization of the legislature. Here, centralization can be achieved by creating strong leadership, through an elevated position of the speaker and through a hierarchical committee structure. For example, the Budget Enforcement Act, passed in the United States under the first Bush administration in the early 1990s, reformed congressional procedures to protect decisions about budgetary parameters reached at the budget summit between the president and the legislature against later modifications. The other dimension regards the relation between the executive and the legislature. The more the constitution puts the two institutions on an equal footing, the more budget agreements between the two must rely on the contracts approach.
Outside enforcement of fiscal discipline

As in other principal-agent relationships, it is possible to pursue enforcement of good fiscal performance with the help of agents who are not directly part of this relationship. In the context of budgetary policies, a number of practices and proposals exist. First, International Monetary Fund (IMF) assistance to countries in financial crises usually comes with the obligation to meet certain fiscal constraints to consolidate the budget. The IMF’s enforcement power rests on the threat that the financial assistance will not be disbursed if the fiscal constraints are violated. But this approach has severe limitations. Assistance programs are based on agreements between the IMF and the executive, and the legislature may not feel bound by the agreement. It is, therefore, doubtful that outside enforcement works in political settings where the executive has weak control over the legislature. Furthermore, the approach works only in times of crisis, when public finances are already in disarray. In more normal times, the IMF has little enforcement power, because it has no penalties to impose.

A second approach has been adopted by the European Union. Member states of the European Monetary Union are subject to the Excessive Deficit Procedure and the rules of the Stability and Growth Pact. These two measures define a process under which the European Commission and the European Council of Ministers monitor the fiscal performance of the member states. The process revolves around numerical targets for the annual budget deficit. According to the Maastricht Treaty, member states with excessive deficits can be subject to penalties ranging from public reprimands to financial fines.

So far, the experience with this arrangement has been mixed. Importantly, there is a strong correlation between the institutional design of the budgeting process and the extent to which countries comply with the EU rules and procedures (von Hagen 2006a). Countries that have adopted the contracts approach typically comply very strongly, while countries that have adopted the delegation approach typically do not. The external enforcement agent can strengthen the effectiveness of a fiscal contract in countries where the political environment calls for the contracts approach to deal with the common pool problem. In countries where the delegation approach is the appropriate one, the fiscal targets an external agent seeks to enforce are unlikely to become effective, because they do not fit the design of the domestic budgeting process.

In developing countries, it may be possible to involve the main donor agencies and institutions in the budgeting process as a mechanism of external enforcement. Specifically, the donors could be asked to approve the set of
fiscal targets negotiated among the members of the executive at the outset of the annual budgeting process. These targets could in turn be anchored in multiannual fiscal programs subject to the donors’ scrutiny. An official approval of these targets by the donors would give these targets additional political weight and protect them against later efforts by domestic interest groups and politicians to unravel the fiscal contract. Compared with outside enforcement by the IMF, this form of involvement would have the advantage of working not only in times of fiscal crises. As in the European case, however, involving the donors as outside enforcement agents can be expected to work only in countries where the contracts approach is appropriate.

Conclusions

Good institutional design of the budgeting process is an important prerequisite of good fiscal performance. This chapter has discussed the main institutional approaches that can be followed to mitigate the principal-agent problem and the common pool problem of public finances.

Budgetary institutions can be designed to reduce the adverse effects of the principal-agent relationship between voters and politicians. The environment in which the budgeting process evolves strongly affects accountability and competitiveness, which are strengthened by ensuring that the budget is comprehensive, that the budgeting process is transparent, and that budgeting is understood as a management exercise and not just a legal one.

The common pool problem of public finances can be reduced by centralizing the budgeting process—that is, by introducing institutional mechanisms that force the actors in the process to take a comprehensive view of the costs and benefits of all public policies. Depending on a country’s political system, this goal can be achieved by means of the delegation approach or the contracts approach.

Institutional reform of the budgeting process is, therefore, an important part of a policy aiming at achieving better fiscal outcomes. This does not mean that a change in legal and procedural rules mechanically produces better results. Nevertheless, a large body of research and practical experience now shows that the outcomes of political decision-making processes are systematically shaped by the institutional environments within which these processes evolve and that reforms of the budgeting process have contributed significantly to achieving better fiscal outcomes. In practice, institutional reforms are often the result of acute fiscal crises, of times when there is widespread awareness of the principal-agent and the common pool problems of public finances and a general recognition of the need for change. Better institutions help to
make this awareness a durable one and thus serve as a commitment device for good fiscal performance.

Notes

1. For a review of this literature as it relates to fiscal policy, see von Hagen (2006b).
5. For example, Mills and Quinet (2002) report estimates from the Organisation for Economic Co-operation and Development of the output gap in France for 1995. The 1995 estimate was below −3.0 percent, whereas the 1999 estimate was −0.5 percent.
6. For a review of the literature, see von Hagen (2006b).
7. Note that in the current context, centralization refers to the internal organization, not the geographic structure of budgetary decisions.
8. See von Hagen (2006b) for a review of this literature.

References


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