# 1

## *Introduction*

In the early 1990s, the most pressing public policy problem in Europe was mounting debt. The average general government debt ratio as a percentage of GDP almost doubled in a little more than a decade, from almost 38% in 1980 to 73% in 1993 (AMECO 2005). These aggregates even conceal the full extent of the problem – in countries like Belgium, Ireland, and Italy the debt ratio moved above 100% of GDP. With these problems evident, the heads of state and government agreed to the road map to a single currency in the form of the Maastricht Treaty in December 1991. The designers of Economic and Monetary Union expected that governments would get their economies in shape before they adopted the new currency, the euro. Member states were consequently supposed to meet five "Maastricht" criteria. The most contentious of the five criteria concerned fiscal policy. States were expected to have general government budget deficits no greater than 3% of GDP and debts no larger than 60% or on a declining path. While the debt level ultimately was not critical, the deficit level was, and in the immediate years after the signing of the Maastricht Treaty in February 1992 it looked as if the euro would not get off the ground because of widespread deficit problems. In 1994, only Ireland and Luxembourg had deficits below 3%. A eurozone without big countries like France and especially Germany would never have been created in the first place.

By 1997, however, all countries but Greece had managed to get their deficits below 3% of GDP, and the Greeks seemingly pushed their deficits below this benchmark to qualify as well in 2000. In 2000 more generally, fiscal policy was healthy. Nine of fifteen European Union countries had budget surpluses. Only Portugal and, as it emerged later, Greece were either near or above the 3% level.[1]

It turned out that this fiscal performance was the calm before the storm. Figures were healthy, but it was not difficult to perform well as the European economies were especially strong. Large sums from the sale of mobile phone frequencies also boosted the revenues of some countries, making fiscal positions seem even stronger than they actually were. A recession hit the European Union countries beginning in 2001. Budget balances dropped from an average of 1.3% of GDP in 2000 to –1.8% by 2003. Five of the twelve countries in the eurozone had deficits above 3% (AMECO 2007).

The European Union had procedures to deal with this situation. The European Commission could recommend that the Union send "early warnings" to member states that would have deficits above 3% in the future. Once member states exceeded this reference value, it could also recommend that countries had "excessive deficits," starting the excessive deficit procedure for such countries. They would then be given deadlines to take measures to correct their deficits. If no action was taken, it was possible under the rules to fine a state.[2] Each step of the process required a Commission recommendation and the approval of a qualified majority of ECOFIN, the gathering of Economic and Finance Ministers. Portugal was found to have an "excessive deficit" in 2001, France and Germany in 2002, and Greece and the Netherlands in 2003. Yet despite these actions the deficits in France and Germany in particular did not improve. When it became clear that France would have a deficit above 3% again in 2004, the third year in a row, the European Commission recommended that ECOFIN place "notices" on France and Germany, a procedure which was one step away from formal sanctions (Morris, Ongena, and Schuknecht 2006, 17). The proposal failed to receive the backing of a qualified majority of member states. The European Commission then took the Council of Ministers to the European Court of Justice on the issue. While the Court did ultimately rule that the Council should not have suspended the punishment mechanism, it also noted that the Council more generally does have discretion (European Commission 2004; *Financial Times*, January 13, 2004). France and Germany ultimately ran "excessive" deficits for another two years, and the member states changed

[1] The Greeks were not as successful as first thought; revised figures a few years later put the deficit at above 4% of GDP in 2000 (AMECO 2007).

[2] An excellent review of the procedures is found in Morris et al. 2006.

the rules through a reform of the Stability and Growth Pact in March 2005.[3]

The discussion of the clash at the European Union level suggests that the European Union–level rules were not effective in maintaining deficits below 3%. At the same time, this is not the whole story. While all countries experienced the same recession in general, some had difficulties while others did not. The puzzle here is why some countries had larger fiscal deteriorations than others. To answer this question, we need to examine the fiscal institutions at the national level and then put them in the European context. How are budgets made in practice? Are some fiscal institutions, norms, and procedures more effective than others? Moreover, how does the overall political environment affect the effectiveness of those very fiscal institutions?

## *Our Approach*

This book makes at least three contributions to the current literature when answering these questions. First, we provide a new theoretical explanation for differences in fiscal performance in Europe. Second, we take seriously the source of fiscal institutions and we endogenize them in our analysis. Finally, we present a new dataset on fiscal institutions, norms, and procedures over a twenty-year period for the fifteen European Union countries that were member states when the euro was introduced in 1999.

In terms of our theoretical argument, we begin with the premise that the way in which governments make budgets has a substantial impact on what those budgets look like, both when they are proposed and when they are executed. Procedures for determining the budget are so important because they affect the overall level of centralization of the budget process. A fundamental characteristic of modern public finances is that governments spend money drawn from a general tax fund on policies targeting specific groups in society. The fact that the group of those who pay for such policies (the general taxpayers) is larger than the group of those who benefit from them implies a divergence between the net benefits accruing to the targeted groups and the net benefits for society as a whole. This incongruity is called the *common pool problem of public finances* (von Hagen and Harden 1996). It causes the targeted groups and the politicians representing them to demand more spending on such policies than is optimal for society as a whole. Thus, the common pool

[3] Both countries managed to get their deficits below 3% of GDP in 2006.

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 (Velasco 2000; von Hagen and Harden 1996; Chapter 2).

This tendency for excessive spending, deficits, and debt increases with the number of politicians drawing on the same general tax fund, a point empirically confirmed by Perotti and Kontopoulos (1999). Ideological and ethnic divisions or ethnolinguistic and religious fractionalizations of societies increase the tendency of people on one side to neglect the tax burden falling on the other side, making the common pool problem more severe. Thus, empirical studies showing that such schisms result in higher spending levels, deficits, and debt confirm the importance of this problem (e.g., Roubini and Sachs 1989; Alesina and Perotti 1995; Annett 2000). The common pool problem also looms large behind vertical fiscal relations within countries. Transfers from the central to local governments imply that residents in one region benefit from taxes paid by residents in other regions. Bailouts of overindebted local governments are a special form of such transfers.

At the heart of the common pool problem of public finances is the 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 if politicians can be made to take a more comprehensive view of the costs and benefits of their decisions. This is the main role of the budget process. The budget process consists of the formal and informal rules governing budgetary decisions of the executive and legislative branches of government. A centralized budget process contains elements that induce decision makers to internalize the common pool externality by taking a comprehensive view of their decisions. A fragmented budget process fails to do that.

We are interested in what we refer to as "forms of fiscal governance" that determine the level of centralization. The term "governance" connotes a broad perspective on the institutions, that is, the system of procedures (or fiscal institutions) in place to make budgets. It is tempting to focus on one procedure or rule only, and to proclaim that the adoption of that rule will "fix" the system. Our contention is that one needs to consider the entire system. Centralization of the process when the cabinet makes a decision may not yield a centralized outcome if parliament can add back in all of the spending that a finance minister excised months earlier. Similarly, a centralized procedure in parliament may have little effect if the common pool problem is rife in the budget the government proposes.

In this book, we develop two alternative roads to greater centralization. *Delegation* involves vesting the finance minister with significant decision-making powers over public monies. The finance minister both plays a dominant role within the cabinet during the proposal stage of the budget process and is responsible for monitoring the execution of the budget and making any necessary changes during the budget's implementation. In contrast, under *contracts* a group of agents with similar decision-making rights (usually political parties) enter an agreement to commit themselves strictly to targets for budget aggregates set for one or more years. These modes contrast with a *fiefdom* form of governance, where the decision-making process is fragmented, ministers dictate their own budgets, and fiscal discipline is consequently lax.

An important insight is that the effectiveness of a given form of fiscal governance depends crucially upon the underlying political system. If parties disagree on basic policy issues about how much should be spent where or on how much a given group in society should be taxed, they are unlikely to allow a finance minister to make decisions on the budget for all of them. Similarly, parties are less likely to delegate powers to one ministry if they expect to compete with one another in future elections. Finance ministers in this situation could use their position to advance their own party's interests at the expense of other parties. This discussion suggests that strengthening the formal powers of a finance minister where there are great ideological differences among the policymakers who are needed to approve the budget will have little practical effect, while a similar strengthening of the finance minister should have a large effect where there is little ideological discord in government, so long as the party or parties are running together in the next election. Alternatively, contracts should work well in places where ideological differences are large and/or where coalition parties are strong competitors for votes. Contracts make explicit the terms of the budgetary agreement, so there is little reason to worry about the motives of the finance minister, whose role is reduced to enforcing the preexisting contract. Because the parties that negotiate contracts consider the full tax burden, they internalize the common pool externality, so the level of centralization is the same as under a strong and effective finance minister.

We use our analytical framework to classify European Union countries during the period 1985–2004. On the basis of our own detailed surveys of finance ministry and central bank officials and members of parliament in

1991, 2000, and 2004 in the fifteen members of the European Union before the May 2004 enlargement, we construct a database describing the prevailing modes of fiscal governance during the twenty-year period. This database allows us to consider whether differences in fiscal institutions lead to differences in fiscal performance. Empirically, we find that countries that should be either *delegation* or *contract* states perform better the more fiscal institutions they adopt that are consistent with their predicted approach.

This discussion has important policy and theoretical implications. On the policy side, one can imagine a situation where a given form of fiscal governance is in place but where the underlying political environment changes. For example, the German government had closely aligned coalition governments under Chancellor Helmut Kohl. The move to a coalition under Chancellor Gerhard Schröder, characterized by policy differences between the Social Democrats and the Greens, and then to the grand coalition government between the Christian and Social Democrats, made the ideological differences larger. Our argument implies that the same set of fiscal institutions that worked well under Kohl should be less effective under Chancellors Schröder and Merkel. Indeed, as indicated before, the Schröder government had serious difficulties with fiscal discipline, which became fully visible in the recession of the early 2000s. The Merkel government enjoyed the double benefits of a tax hike and a strong global economy in its early years, but the verdict is still out on what it actually achieved to improve Germany's long-term fiscal health. We provide further strong empirical evidence that institutional effectiveness varies both across countries and within them depending upon the relevant underlying policy differences.

On the theoretical side, the comparative politics literature has increasingly focused on how different types of institutions interact and even reinforce one another, with one prominent approach focused on political system institutions and another on actors in the economy. Lijphart (1999) proposes two ideal types of systems, majoritarian and consensual. The former group of states have institutions that reinforce the power of a majority in a given country to enact legislation. They therefore usually have plurality electoral systems and two parties in the legislature, which, in turn, elect one-party majority governments. Consensual systems, in contrast, have political systems designed to require the assent of several groups in society, not just a simple majority, for there to be policy change. Such countries usually have proportional representation systems, many parties in the legislature, and multiparty coalition governments.

Rather than focusing on the characteristics of the political system, the varieties-of-capitalism approach (e.g., Hall and Soskice 2001) is actor-centered and discusses especially the requirements of firms. Firms face a series of coordination problems, be they industrial relations, vocational education and training, corporate governance and financing, or interfirm relations. There are two ideal sets of institutions to resolve these problems, which, in turn, lead to the ideal types of liberal market economies and coordinated market economies. In the former, institutions provide coordination through competitive market arrangements. Firms in the former economies receive market financing, support fluid labor markets, and expect employees to have general skills so that there is an emphasis on in-house training. Firms regard competition with each other as zero-sum, and there is little or no cooperation on research and development. Their counterparts in coordinated market economies, in contrast, receive some financing from more patient capital, such as banks; support more rigid labor markets; and expect employees to have more specialized skills that all firms in an industry have helped develop. There is some cooperation on research and development.

While we will explore some of the implications of this book for the respective literatures in more detail in the concluding chapter, we would like to emphasize at the outset that our work has important links with both of them. Like Lijphart, we consider the effects of electoral and party systems. Yet we add an important, and so far neglected, piece to the puzzle, namely, how these systemic variables affect the way governments organize themselves to produce policy. Moreover, we identify which parts of Lijphart's framework matter most. One would expect delegation to a strong finance minister in one of Lijphart's majoritarian systems, for example, but the reasoning in our case is that there is a one-party majority government in office. If the form of government shifts to a multiparty coalition, fiscal contracts would then be expected.

There are similar linkages with the varieties-of-capitalism literature. The solutions that firms reach for their coordination problems are achieved in the context of certain policy institutions or request some policy intervention. They are linked to the decision-making mechanisms of the set of actors who appear in government. Rather than firms, it is the set of political parties or government actors that have to reach agreements that are positive-sum. The varieties-of-capitalism approach has argued that government structures, and in particular the constellation of parties in government, have implications for the investment structure and for the relationship with employer and workers' associations. Much in line with the basic idea advanced in our approach for fiscal policies, coalition governments facilitate coordination with social partners because they may find it more difficult to change the policy stance, which renders trust in policy stability. By comparison, policy positions of powerful single-party governments – as in the United Kingdom – may be perceived as too changeable to generate trust and coordination (Hall and Soskice 2001). Therefore, the correspondence between the different types of institutions, that is, fiscal institutions in our case and firm-based institutions under the varieties-of-capitalism approach, is more than a coincidence. Countries we predict in our book should have long periods of fiscal contracts, such as Belgium, Finland, and the Netherlands, are all classified as coordinated market economies. However, the concrete assessment may also differ, because different institutional characteristics are taken into account. Most notably, while a delegation state would be suitable both for the United Kingdom and for Germany, the varieties-of-capitalism approach classifies them as different types of economies with contrasting forms of government-business coordination. We will explore further the possible relationship between the two in the Conclusion.

### *Outline of the Rest of the Book*

The rest of the book proceeds as follows. Chapter 2 discusses the work done in political economy to date on fiscal institutions and fiscal performance. One strand of the literature, including landmark works like Roubini and Sachs (1989) and Persson and Tabellini (2000, 2004), considers how political institutions affect fiscal performance. Another strand, including most notably Wildavsky's early work, looks only at fiscal rules. Our book integrates both strands by considering packages of fiscal rules as forms of fiscal governance. All governments face a common pool resource (CPR) problem because policymakers potentially do not consider the full tax implications of their spending decisions. One form of governance is fiefdom, which arises when the budget process is decentralized. Fiscal discipline should be lax under fiefdom. Two alternative forms of governance, delegation and contracts, represent solutions to the CPR problem. These forms of fiscal governance differ in their functionality for the prevailing type of government in EU member states. Electoral systems shape the type of government and the inherent principal-agent problem for fiscal governance. *Contracts* are appropriate for countries with a proportionality rule, which tends to produce coalition governments. *Delegation* is the choice for countries with plurality rule or other systems that produce single-party governments (or the functional equivalent – governments where the same parties run together as a bloc in election after election, as in France and Germany).

Chapter 3 uses the theoretical framework to classify countries according to the forms of fiscal governance over the period 1985–2004. It presents a novel dataset to develop indices to consider how closely a given country fits either the "delegation" or "contracts" ideal. It finds that there has been a general improvement in the centralization of the budget process in most countries, but also that there remain significant differences between countries.

Chapter 4 explores whether these differences have real effects on budgetary performance. We consider in particular how forms of fiscal governance affect budget deficits, debts, expenditures, and forecasting errors. It finds that *delegation* and *contract* states are equally adept at maintaining fiscal discipline, while *fiefdom* leads to higher deficits, debt levels, and expenditure growth. Governments with elements of contracting in place are generally more conservative in economic forecasts than governments under either *delegation* or *fiefdom* forms of governance.

Chapter 5 then addresses the endogeneity question, namely: Why does a country adopt a given set of fiscal institutions, and why do these institutions sometimes approach one of the theoretical ideals we provide (delegation or contracts) and sometimes not? We suppose that populations face the same common pool problem that their representatives face. Why should they support politicians who are in favor of centralizing the budget process? We consider the role that fiscal crises play in informing populations and politicians alike about the consequences of decentralized political institutions. We find that countries with histories of fiscal crises have adopted more robust fiscal institutions. The expected form of fiscal governance matters as well. Countries make changes consistent with the form of governance that should perform best given the underlying political conditions. A brief case study of the Netherlands after 2000 provides more detail about how and why governments change their fiscal institutions when they do.

Chapter 6 considers the development of fiscal institutions in the accession countries in Central and Eastern Europe. These countries generally had to introduce new fiscal systems after the initiation of democracy and the move from a planned to a market economy in the early 1990s. Unlike in the countries analyzed in Chapter 5, the development of fiscal institutions is not burdened to the same extent by history and tradition. What sort of fiscal institutions did they adopt, and why did they choose some institutions and not others? We present fiscal institutional data from these countries. We find that experience with fiscal crises in the formative years of the new democracy as well as greater levels of ethnic fragmentation lead to more centralized fiscal institutions. At the same time, our argument would predict that fiscal contracts would be appropriate in all countries but Hungary and (maybe) Bulgaria, and no country has a form of fiscal governance that approaches contracts. More reforms of fiscal institutions in these countries are needed. The chapter concludes with a case study of the evolution of Polish fiscal governance.

Chapter 7 expands the focus to the European Union. It considers the interplay between national and European Union institutions. The delegation approach hinges on the delegation of power to the minister of finance to overcome the coordination problem inherent in budgetary decision making; the contract approach instead relies on preestablished budgetary targets and rules. The European Union rules reinforce the use of targets at the national level, but they do little to strengthen finance ministers. The contract approach, therefore, seems to be much more compatible with the European fiscal framework than the delegation approach. We propose the creation of a Sustainability Council for Europe that would provide additional support for domestic fiscal institutions.

The Conclusion discusses fruitful avenues for future work. The policy implications of our research are clear. The design of fiscal institutions for a given country depends critically upon the underlying political structure. All countries do need to centralize their budget processes, but there is no one-size-fits-all prescription on how best to do it. On the theoretical side, our work builds on the existing comparative political literature in several ways. The relative stability of delegation or fiscal contracts may depend on the variables the broader literature has identified, such as party systems. At the same time, our work provides a new framework to consider how party systems affect institutional choices and how these institutions that structure how governments make decisions have real policy consequences. On this account, the comparative perspective in this book complements and expands the insights from the literature in the field in two respects. First, our argument is truly comparative in the sense that it explains the variation of politics across countries. In Tilly's (1984) classification of comparative work, our approach is variation-finding, although the basic mechanism is derived from a general political economy argument. In this respect, this