

Budget Procedures and Institutions Influence Budget Outcomes

Reviewing current theoretical work and recent empirical data from industrial and Latin American countries, Alberto Alesina and Roberto Perotti, in an IMF Working Paper entitled *Budget Deficits and Budget Institutions*, conclude that the variety of ways in which countries prepare their budgets, navigate the legislative approval process, and implement these budgets helps determine the degree of fiscal discipline exercised. Drawing from this survey of current research and data, the authors recommend an appropriate role for hierarchical procedures in the budget process, the creation of independent budget institutions, and the development of rules and practices that ensure accuracy and transparency in public budgets.

Over the past thirty years, public debt-to-GNP ratios have grown markedly in many industrial countries. In some instances, debt ratios have even exceeded 100 percent. Paralleling this sharp climb in debt ratios has been a dramatic change in the factors responsible for the growth of public debt. While twenty years ago the purchase of goods and services would have been the main such factor, transfers now play the major role in public deficits and debt. Transfers, which have proven notoriously difficult to cut because of their broad popularity with the electorate, have immeasurably complicated the process of fiscal adjustment.

Budgetary Institutions

Budgetary institutions encompass all the rules and regulations governing the drafting, approval, and implementation

of the budget. Typically, a constellation of social, political, and historical factors have shaped these budget institutions over time, but the growth and persistence of deficits in recent decades have led countries to re-examine what could be done to promote more effective fiscal discipline.

A number of countries have weighed the merits of a balanced bud-

Industrial country budgets are notably complex, but not always out of necessity.

get law, but Alesina and Perotti contend that this legal fix is neither necessary nor sufficient to achieve fiscal discipline. They cite both Keynesian objections (the straightjacket imposed on policymakers who wish to pursue countercyclical measures) and tax-smoothing goals (a balanced budget would constrain the appropriate use of budget deficits and surpluses over the cycle, which constitutes an optimal tax-smoothing policy). Appropriate procedures, argue the authors, need not sacrifice flexibility for fiscal discipline.

The key is developing appropriate budget procedures and creating greater budget transparency, according to the authors. They identify two crucial elements: appropriate voting procedures in the formulation and approval of the budget and enhanced transparency to reduce the opportunities for “creative budgeting.”

Voting Procedures. A vital question in any examination of budget institutions is who wields power (and when) in

the budget process. Two models exist: a hierarchical one in which key ministers exercise considerable power, and a collegial model in which power is more equally dispersed. More hierarchical budget institutions accord the prime minister or finance minister pre-eminence vis-à-vis other spending ministers. The natural constituencies for the spending ministries tend to be groups or industries that will benefit from spending, while the finance ministry’s constituency is, at least in theory, the “average” taxpayer. Drawing on both theoretical literature and empirical evidence, Alesina and Perotti

conclude that any procedural arrangement that increases the relative power of the finance minister is likely to increase fiscal discipline.

France and the United Kingdom provide the clearest examples of hierarchical arrangements. Neither of these countries has a debt problem, the authors underscore, despite a very large public sector in France and a relatively low rate of economic growth over the past two decades in the United Kingdom. By contrast, countries in which the treasury ministry has not been accorded special status figure prominently among the industrial countries with the highest debt-to-GNP ratios (Ireland, Italy, and Belgium) as well as among those with rapidly rising debt ratios.

Hierarchical and collegial models also figure in the budget approval process. Typically, say Alesina and Perotti, legislators in both parliamentary and U.S.-type democracies are viewed as the “big spenders.” Limiting the types

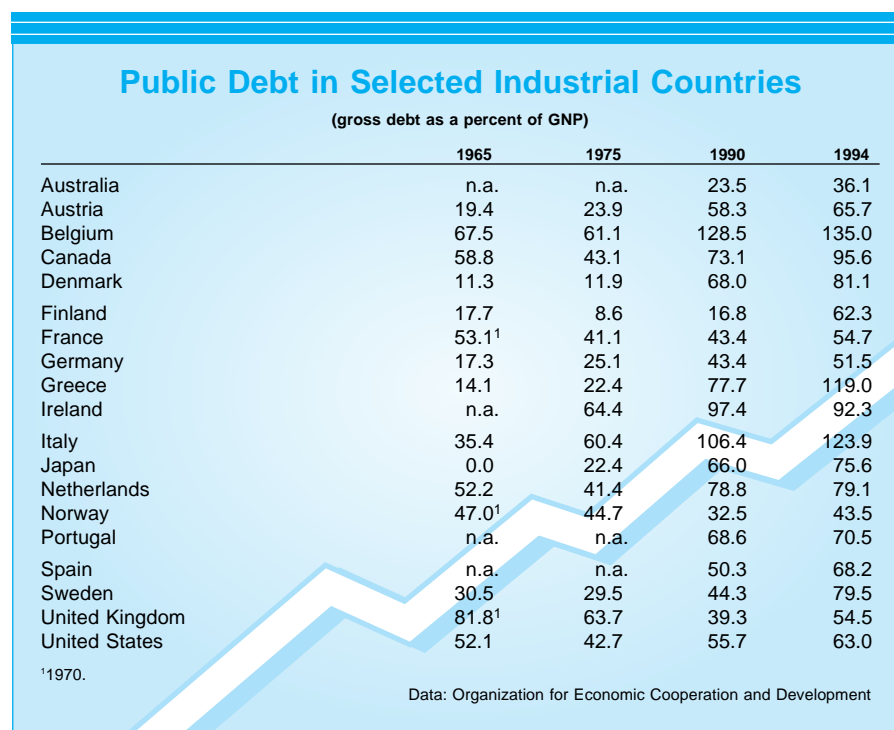
of amendments that can be offered at the legislative stage is equated with greater fiscal responsibility. An attendant aspect is the seriousness of a rejection of a budget proposal. In some systems, such a rejection simply triggers a new budget proposal; in others, it can lead to the fall of the government. In certain situations, the higher risk attached to passage of the budget imposes a greater sense of responsibility on both the executive and legislative branches.

The rules governing the legislative debate of the budget are similarly important. A “closed rule” sharply limits the capacity of the legislature to amend the executive’s proposal, while an “open rule” affords substantial opportunity to amend it. Closed rules strengthen the hand of the executive. Comparative empirical evidence suggests that France possesses the most authoritarian approval procedures, while collegial procedures characterize Italy, Greece, and Denmark.

Ultimately, both theoretical research and practical country experience suggest that the more hierarchical institutions promote fiscal restraint and are more likely to avoid large and persistent deficits and to implement fiscal adjustments more promptly. But they do so at a cost, the authors say, since hierarchical institutions customarily generate budgets that explicitly favor majority interests.

Optimally, both extremes should be avoided. An open rule, for example, can be designed to accommodate amendments that do not increase the size of the budget deficit or spending. Or a mix of rules can include a closed rule for the size of the budget, and an open rule for amendments to the budget’s composition. Thus, the executive’s hand could be strengthened to pursue fiscal adjustment, while collegiality is preserved in purely allocative matters.

Transparency. Industrial country budgets are notably complex, but not always



out of necessity. Complexity may offer its own advantages, observe Alesina and Perotti, affording opportunities for creative budgeting and allowing governments to more easily hide liabilities by shifting them to future budgets or by using off-budget funding sources. Governments have a variety of “tricks” at their disposal, including:

- Overestimating the expected growth of the economy, so that tax revenues are overestimated and interest rates and outlays are underestimated. “Bad luck” is then blamed for the “unexpected” additional deficit at year’s end.
- Overoptimistic forecasts that inflate the revenue potential of certain new policies, notably proposed tax increases.
- Creative budgeting that permits various items to be kept off the national budget.
- Strategic use of budget projections, particularly manipulation of the key “baseline.” By inflating the baseline, politicians can create the illusion of fiscal conservatism without real

costs to their constituencies. This illusion cannot be sustained indefinitely, but it can confuse the electorate and delay a realistic appreciation of the actual state of public finances.

- Strategic use of multiyear budgeting. A three-year adjustment plan in which all the hard choices take place in year three in effect “buys time.” Subsequent multiyear budgets, of course, provide the opportunity for further postponement.

Alesina and Perotti note that two high-debt industrial countries, Italy and Ireland, have the least transparent budgets. This observation is bolstered by evidence from Latin America, where more hierarchical and transparent procedures were associated with lower primary deficits during 1980–93.

While the growing body of literature on budget institutions and procedures broadly confirms the link between fiscal responsibility and hierarchical procedures and transparency, Alesina and Perotti caution that further study will be needed in a number of areas. These include the need to weigh the impact

of specific procedures, gauge the effect of other political and economic variables, determine when budget deficits appeared and measure the impact of institutional reforms.

Although Alesina and Perotti's review of the literature focuses on parliamentary democracies, the experience of the United States broadly reinforces their findings. In both political systems:

- Budget deficits seem to derive from the delayed fiscal adjustment of fragmented governments (coalition government in the parliamentary systems and divided government—executive and legislative branches of different parties—in the United States).

- Budget institutions influence budget outcomes in the expected direction.

- More hierarchical institutions appear to be particularly necessary and useful in instances of fragmented government.

Alesina and Perotti emphasize that collegial institutions and fragmented governments do not in themselves cause budget deficits, but they do delay the response to fiscal imbalances once they appear. Thus, the complex interaction of oil shocks in the 1970s, lower economic growth, and aging populations, combined with certain budget procedures and fragmented government influenced both the emergence of deficits and the considerable cross-country variation in the level of the deficit.

Recommendations

Different budget procedures respond to different needs and are aimed at different goals. Since these needs and goals change over time, Alesina and Perotti counsel flexibility. A high-debt country, for example, may benefit from certain budget procedures that a low-budget-deficit country would find needlessly restraining and hierar-

chical. A possible solution, the authors conclude, would be contingent procedures that invoke more hierarchical procedures when the budget deficit rises above a prescribed threshold—say, 60 percent of GNP. Such a threshold would create positive incentives for those who favor deficits to be more restrained, since triggering a more hierarchical set of procedures would reduce their influence in the budget process. A possible administrative and practical headache, however, would be a debt-to-GNP ratio that oscillates around the trigger point.

To achieve greater transparency and a reduction in the scope for creative budgeting, Alesina and Perotti suggest the creation of an independent agency that “supervises the accuracy and transparency of the budget, based on a set of reasonably well-defined rules.” The budget institution's independence should mimic that of a central bank's. To further strengthen the independence and impartiality of this budget agency, the authors suggest using forecasts based on an average of international organization and private forecasts, employing reputable accounting firms to confirm the impartiality of the budget, and creating simple, clear, and transparent implementation guidelines to discourage creative budgeting. ■

Copies of IMF Working Paper 96/52, *Budget Deficits and Budget Institutions*, by Alberto Alesina and Roberto Perotti, are available for \$7.00 from Publication Services, Box XS600, International Monetary Fund, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax (202) 623-7201; Internet: publications@imf.org