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The design of fiscal rules and forms of governance in European Union countries

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Abstract

This paper uses a new data set on budgetary institutions in Europe to examine the impact of fiscal rules and budget procedures in EU countries on public finances. It briefly describes the main pattern of budgetary institutions and their determinants across the EU 15 member states. Empirical evidence for the time period 1985–2004 suggests that the centralisation of budgeting procedures restrains public debt. In countries with one-party governments or coalition governments where parties are closely aligned and where political competition among them is low, this is achieved by the delegation of decision-making power to the minister of finance. Fiscal contracts that require countries to set multi-year targets and that reinforce those targets increase fiscal discipline in countries with ideologically dispersed coalitions and where parties regularly compete against each other.

JEL classification: H11; H61; H62
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1. Introduction

The past two decades have seen a strong and growing interest in fiscal policy rules aimed at containing public sector deficits and reducing public sector debts. Fiscal policy rules specify numerical targets for annual government deficits, debts, or spending. They have a venerable

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history at the sub-national level, and some countries have used less specific ones — such as the 'golden rule' that limits annual government borrowing to investment spending — at the national level for a long time. What is new is the application of specific annual targets at the national level. The Maastricht Treaty and the Stability and Growth Pact establish a European fiscal framework based on fiscal rules expressed as deficit and debt limits which national governments are expected to follow.

This interest in fiscal rules is a reaction to the experience in many countries of rapidly rising debt levels and unsustainable deficits in the 1970s and 1980s. But while rules seem attractive and straightforward to contain the spending and borrowing bias of profligate governments, it is by no means clear what institutional design they need and how they should be embedded into the government budgeting process to be effective. In the EU, all member states face the same fiscal policy framework, but there is considerable variation in the budgeting institutions at the national level. This variation is due to characteristics of the political and, in particular, the electoral systems. In this paper, we analyse the impact of fiscal rules on the sustainability of public finances with a focus on the interaction between rules and budgeting processes.

Hallerberg and von Hagen (1999) show that European governments have developed two types of budget processes promoting fiscal discipline. Under the "delegation" approach, the budget process lends special agenda-setting powers in the preparation of the budget to the minister of finance. Under the "contract" approach, in contrast, the budget process hinges on pre-established, numerical budgetary targets negotiated among key policy makers. This approach strongly resembles the characteristics of a fiscal rule and, at a first glance, it is more compatible with the design of the European fiscal framework than the delegation approach. As a result, the European framework may be less effective in countries whose budget process is shaped by the delegation approach. Furthermore, Hallerberg and von Hagen (1999) argue that the differences between these two approaches reflect countries' basic political characteristics such as party and electoral systems, implying that the two are not easily interchangeable for a given country. Countries which typically have one-party governments or coalitions of closely aligned parties are more likely to adopt the delegation approach, while countries which typically have more dispersed coalition governments are more likely to adopt the contract approach. This suggests that differences in the effectiveness of the European fiscal framework could be a permanent feature of the European Monetary Union and changes in this framework might be needed to achieve an equal degree of fiscal discipline in the EU.

In this paper we extend the analysis in Hallerberg and von Hagen (1999). We start with a characterization of the budgetary institutions at the start of Stage III of EMU and their evolution over the past decade using a new institutional data set. We show that there is a correspondence between the choice of budgeting processes and national political systems in line with our theoretical predictions. Several states which we expect to adopt the delegation approach given their political systems did develop stronger budgeting institutions most consistent with this approach during the 1990s. At the same time, countries we expect to adopt the contract approach strengthened the contracting elements of their budgeting rules. Next, we explore the effect of these institutions with respect to the growth of public debt. As expected, delegation in budgeting procedures and more stringent fiscal rules both contribute to fiscal discipline. Moreover, more stringent fiscal rules work in countries with dispersed government coalitions, whereas delegation is effective only in states with single-party governments or closely aligned coalitions. The punchline is that both the delegation and contract approaches provide effective instruments to increase fiscal discipline so long as they match the pre-existing government structure.