BUDGET PROCEDURES, FISCAL RULES AND FISCAL PLANNING IN EU COUNTRIES: IMPLICATIONS FOR DIFFERENT FISCAL GOVERNANCE FORMS

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Abstract

This paper has identified broadly the same forms of fiscal governance in the EU Member States as those confirmed at the first decade of this millennium, be it mainly contract or delegation approach. Theoretic assumptions regarding these two approaches have been confirmed to a certain extent: contract states have performed better in terms of multiannual budgetary planning, setting expenditure ceilings, or constraints set by fiscal rules. Delegation states aim at a more prominent role of the Minister of Finance in resolving budgetary disputes between ministries. Both forms show rather mixed performance in the phase of legislative budget negotiations. Regarding flexibility of budgeting after legislative approval, convergence between contract and delegation forms of governance is observed. Regarding impacts on fiscal outcomes, numerical fiscal rules were successful in constraining discretionary behaviour of fiscal policies, more prominently in delegation states. Categorization between contract and delegation states has not been proved, regarding the successful impact of medium-term budgetary frameworks on fiscal discipline. As anticipated, economic and electoral cycles, as well as ideological differences in the government, appeared more prominent in delegation states. The findings point to the high stability of fiscal governance forms and their implications.

Keywords: Deficit Bias, Fiscal Governance, Fiscal Rules, Budget Process

JEL Code: E62, H61, H62

Introduction

The fiscal policy behaviour in Europe has been in the centre of interest of the academic environment, and so has the deficit bias which may be caused by several factors. One of them is the common-pool problem (Poterba and Hagen, 1999; Calmfors and Wren-Lewis, 2011), meaning that government spending is targeted at a certain group of society even though such spending is financed by all tax-payers. Many spending ministries and other decision-makers may participate in the budgetary process and may favour certain policy programmes at the expense of all taxpayers. Such fragmented policy-making may incur higher deficit and debt. Several forms of fiscal governance, as an institutional solution to such fragmentation, have been identified in the EU countries at the turn of the millennium, be it mainly contract or delegation approach (Hallerberg and Hagen, 1997; Hallerberg and Yläoutinen, 2010). The "delegation" form involves transferring important budgetary decisions to one key player that most probably takes into consideration the problem of full financing by taxpayers, typically the finance minister. This discretionary approach is typical in one-party (or ideologically like-minded) governments. On the other hand, coalition parties negotiate key budget parameters and rely on a commonly agreed set of rules, typically in government parties with wider ideological differences (Hallerberg, 2010).

This paper updates and extends the previous research on forms of fiscal governance and their impact on fiscal policy-making. The methodological approach is based mainly on Hallerberg et al. (2004) and also inspired by Hallerberg and Hagen (1997), Hallerberg and Yläoutinen (2010). First, the current forms of fiscal governance were identified, based on electoral systems, district magnitudes, number of government parties, coalition changes and differences in ideologies among coalition parties[1], as these highly determine the fiscal governance approaches. Second, using the *International Budget Practices and Procedures Database* (OECD, 2007, 2012, 2018), the relevance of key parameters (regarding the draft budget at the government and parliamentary level, budget execution and multiannual fiscal planning) was assessed in the light of estimated fiscal governance forms. Last, the impact of several economic, structural and institutional aspects on discretionary fiscal policy were assessed, with panel regression in the form of fiscal reaction function.

1 Fiscal governance forms in the EU Member States

In this paper, the current fiscal governance forms have been estimated using broadly the same approach as Hallerberg et al. (2004): the description of the electoral system and other aspects determining the government constellation (see tab. 1) is an important step to characterize the form of fiscal governance in each EU country. Tab. 1 shows only two Member States as a typical example characterizing a contract or a delegation state. A mixed form of fiscal

[1] The last three aspects have been taken as the average over 1980-2019. The time series have been narrowed in countries of Central and Eastern Europe.

governance has been confirmed only in the case of Denmark and Sweden, meaning that the government parties between 1980 and 2019 (with some exceptions) failed to gain an absolute majority in the parliament and that they need to negotiate the draft budget with the opposition.

Tab. 1: Electoral System, Government Composition and Forms of Fiscal Governance[2]

Country	Electoral System	Representatives per Electoral District	Government Parties	Change of Governing Parties (%)	Distance in Ideology	Fiscal Governance Form
Belgium	proportional	13,6	4,5	60,9	0,31	Contract
UK	plurality	1	1,1	23,1	0,04	Delegation

Source: The electoral system and the district magnitude were described based on ESCE (2016). Data in the fourth to the sixth column were calculated as average values using the database by Döring and Philip (2020).

To estimate the relevant form of fiscal governance, two coalition parties are used as an indicative threshold, indicating a relatively stable government coalition across the period of 1980 to 2019 (see footnote 2 for exceptions). Competitiveness of political parties (i.e. change in governing parties) of 50 % constitutes another threshold. Based on these thresholds some countries can be easily classified as delegation states (Austria, Germany, Spain, the United Kingdom, Malta and Portugal), and as contract states (Belgium, Finland, Czechia, Ireland, Italy, Lithuania, Estonia, Croatia, Latvia, the Netherlands, Poland, Romania, Slovakia, Slovenia). However, some borderline cases have been identified:

In Cyprus, although the average number of coalition parties was 2.3, the competitiveness in forming a government was less than 50 %. Cyprus also experienced relatively stable coalition periods of 5 to 13 years without changes in ideological range. As for France and Hungary, the ideological range was relatively low in the coalition parties (0.14 and 0.13, respectively), as well as their low district magnitudes (1 and 1.9, respectively). Greece had a relatively low ideological range (0.10) and an average number of coalition parties (1.3). In Luxembourg, there have been three parties in the government since 2013 which together have gained an absolute majority in the parliament and whose ideological range has widened (0.26). Bulgaria has been included among the contract states given the second-highest level of competitiveness of political parties (93.3 %).

[2] The data relevant for the fourth to sixth column cover the period of 1980-2019. For countries that accessed the EU as of 2004 (excluding Cyprus and Malta), data starting from the turn of the 1980s and 1990s (i.e. 1989 to 1992) were used. Calculation of the ideological range is based on the database by Döring and Philip (2020), where each government party is assigned a value from 0 (i.e. the far left) to 10 (i.e. the far right). The difference between the highest and the lowest value is normalized to a scale from 0 to 1.

The same forms of fiscal government have been identified in almost all EU countries as those identified by Hallerberg and Yläoutinen (2010) or Hallerberg et al. (2004). This was expected, as Hallerberg (2016) considers these forms of fiscal governance quite stable. The only exception was Slovenia, which has been classified among contract states inter alia due to change in coalition at each government, and quite high average number of coalition parties (3.7).

2 Budgeting in different forms of fiscal governance

Having estimated forms of fiscal governance in EU countries, this chapter assesses the key aspects of budgetary processes and rules in the context of contract or delegation forms. All the data used are available in the OECD database (OECD 2007, 2012, 2018). The database does not contain information on eight EU countries (the Baltics, Cyprus, Malta, Bulgaria, Romania and Croatia).

In the context of multiannual expenditure planning, all the 20 states broadly moved to the planning of aggregate expenditures in 2018, whereas in 2007 the coverage of expenditure was close rather to expenditure planning at the ministerial level. The contract states broadly achieved higher coverage of expenditure planning between 2007 and 2018 compared to the delegation states. In addition, over the whole period, the degree of commitment of budgetary targets broadly increased towards legal nature (i.e. in all countries except the UK), while in 2007 six countries kept only indicative nature of their target. In contract states, there was a higher degree of commitment than in delegation states throughout the whole period. The time horizon of expenditure planning was shorter broadly in delegation states than in contract states in 2007, but the findings for 2012 and 2018 do not support the assumption of a longer time horizon in contract states.

Regarding the process of budget drafting by the government, all 20 countries are limited with budgetary constraints (i.e. fiscal rules numerically defined): since the last revision of the Stability and Growth Pact (2011), both balanced-budget rule and expenditure rule apply to all EU countries, which allows more targeted approach in overcoming the deficit bias. However, in 2007, nine countries were subject to debt and budget-balanced rule. When it comes to budget disputes resolution among the ministry preparing the draft budget and the spending ministries, the findings have broadly confirmed the assumption that in contract states the government (or inter-ministerial committee) resolves such disputes collectively. In delegation states, the final word belongs predominantly to the minister of finance. Another aspect is the government power to set expenditure ceilings: between 2007 and 2018, there was a shift towards centralization, from power to "set expenditure ceilings only to a certain extent" to "set the ceilings of all expenditures to all ministries". Indeed, the contract states have on average greater power to limit expenditure ceilings of all ministries than the delegation states. If the government has more than two coalition parties, with a larger ideological range, the need to introduce ceilings for each ministry is needed in the interest of limiting the deficit bias.

Regarding the approval process of the draft budget in the parliament, the governments in delegation states had, on average, a stronger position vis-à-vis the parliament, which can be expected as delegation states should more easily enforce their draft budget in the parliament. Nonetheless, in 2018, both forms of fiscal governance reached a comparable level, thus confirmation of the stronger position of delegation governments to parliament has not been confirmed. In all 20 EU countries (except Ireland), the parliament has either unlimited or limited power to amend the draft budget. In 10 countries (as of 2018), voting the budget means expressing confidence to the government. As expected, this aspect has been more frequent in contract states, from 2007 to 2018. This would motivate the coalition parties to move towards higher fiscal discipline to avoid the resignation risk. On the other hand, in 2012 and 2018, delegation states shifted towards higher centralization than contract states when it comes to voting first the total expenditure before proceeding to a vote on budget chapters. Nonetheless, voting first on overall expenditure is relevant only to six countries. As for the government's right to veto the budget approved by the parliament, such aspect has been identified only in Slovenia. In this respect, any categorization between forms of fiscal governance is impossible.

And last, the flexibility of budget execution has been observed. Between 2007 and 2018, the observed Member States shifted in the direction of setting appropriations that specify operating expenditures of the executive authorities. In 2018, such centralization was more prominent in contract states, unlike in 2007 and 2012. When it comes to increasing expenditures approved by the legislation, the observed countries broadly moved towards higher constraints on the increase, requiring the approval of the parliament or the ministry preparing the draft budget. Regarding the power to decrease or cancel such expenditures, the countries evolved towards reducing (or cancelling) them to a certain extent without the need for any approval. The carry-over provisions regarding unused funds also broadly evolved in the direction of using such power to a certain extent, not requiring any approval. Overall, all of the abovementioned elements of flexibility in budget implementation experienced a convergence between delegation and contract forms of fiscal governance.

3 Fiscal rules and fiscal planning: fiscal impacts

Each aspect of budgetary procedures from the previous chapter was normalised to values from 0 to 4 (and then normalized to 0-1 for regression purposes). Each of these aspects was included in simple regressions to prove whether they have a positive effect on cyclically-adjusted primary balance (reflecting discretionary behaviour of fiscal policy). As only three years (2007, 2012, 2018) were covered, the values for the remaining years were calculated as the weighted average of each institutional aspect[3]. As only three aspects proved statistically significant (budgetary constraints set by numerical fiscal rules, planning horizon and aggregation of planned expenditure), more robust regressions (in a form of fiscal reaction function, inspired by Hallerberg et al., 2004) were applied to determine how the numerical fiscal rules and medium-term fiscal planning influence the discretionary fiscal policy (as shown in tab. 2).

Tab. 2: Panel regression results from a sample of 27 EU countries (1995-2019)

	Dependent vairable: cyclically-adjusted primary balance (CAPB)			
Independent variable	**27 EU states**	**Constract states**	**Non-contract states**	**Delegation states**
Constant	2,03 (1,63)	−1,08 (2,85)	−2,29** (0,99)	−2,06* (0,98)
Lagged CAPB	0,56*** (0,05)	0,51*** (0,05)	0,57*** (0,06)	0,55*** (0,07)
Real GDP growth	−0,07* (0,04)	−0,02 (0,04)	−0,20** (0,09)	−0,26** (0,10)
Change in unemployment rate	−0,15 (0,13)	−0,06 (0,16)	−0,39** (0,13)	−0,45*** (0,13)
Lagged interest payable	0,44*** (0,10)	0,58*** (0,10)	0,36*** (0,10)	0,24** (0,09)
Election year	−0,35* (0,17)	−0,17 (0,17)	−0,64** (0,28)	−0,74** (0,31)
Ideological range	−0,05 (0,17)	−0,25 (0,17)	0,23* (0,12)	0,24* (0,13)

[3] The weights were defined as 0 to 1 depending on the distance between the years included in the OECD database (2007, 2012 and 2018).

Openess[1)]	0,25 (0,53)	0,10 (0,59)	0,54** (0,18)	0,57** (0,20)
Population[2)]	−0,94** (0,34)	0,20 (0,80)	0,05 (0,03)	0,05 (0,03)
Output volatility[3)]	0,11 (0,13)	−0,07 (0,10)	0,18 (0,22)	0,25 (0,25)
Fiscal rules index[4)]	0,27*** (0,08)	0,32*** (0,10)	0,28** (0,12)	0,36** (0,15)
5 years before euro	0,45*** (0,15)	0,55** (0,20)	0,001*** (0,00)	1,16*** (0,32)
Regression method	Fixed effects	Fixed effects	OLS	OLS
R^2	0,47	0,47	0,64	0,60
N	645	359	286	238

Source: own processing. Robust standard errors in paratheses. Coefficient statistically significant at: ***= 1% significance level, **= 5% significance level, *= 10% significance level. Arellano estimator included in all regressions. Croatia was excluded due to a rather short time series of fiscal data. Non-contract states include delegation and mixed states. [1)]Sum of export and import values to GDP. [2)]Population of an EU country to EU28 population. [3)]Standard deviation of growth of real GDP spanning the previous 10 years. [4)]Index as calculated in the Commission's Fiscal Governance Database (the same applies to medium-term budgetary framework index).

As the regressions show, the negative sign of the real GDP growth coefficient implies a procyclical pattern of fiscal policy. This pattern is more prominent in non-contract and delegation states. Hagen (1992), Hallerberg et al. (2004) also anticipate the greater influence of the economic cycle, given that large coalitions in a more competitive party system may be limited by commonly agreed budgetary rules. In addition, the coalition parties experience more difficulties agreeing on deepening the deficit, as not all ruling parties would benefit from it equally. The influence of the electoral cycle was also proved, given the negative sign of the “election year” dummy variable coefficient. In other words, EU Member States tend to deepen their deficits during election years. The electoral cycle is even more apparent in non-contract and delegation states: ideologically like-minded governments tend to benefit from pre-election budget expansion. On the other hand, the existence of an electoral cycle was not proved in contract states. The influence of the ideological range on fiscal policy-making is also proved, specifically in non-contract and delegation states: the more the ruling parties differ ideologically, the more difficult they find it to agree on deepening the deficit. The population variable, together with the negative sign, suggests that highly-populated countries have a larger influence on the implementation of EU fiscal rules and that policy-makers in those countries have less incentive to avoid reputational costs for non-compliance with these rules. And finally, as shown with the fiscal rule index (FRI), stricter national fiscal rules lead to higher budget balances, which is also relevant to all forms of fiscal governance. For contracting states, the significance level is higher than in the other two groups included in the regressions. As expected, average values of FRI in contract states indeed exceeded those in delegation states, in the period of 1993 to 2019 (with exception of 2013). However, as shown with the FRI slopes, the fiscal rules contribute to higher balances in delegation states. Thus, the higher influence of national numerical fiscal rules in contract states has not been confirmed.

The same panel regressions as in tab. 2 have also been applied with the inclusion of the medium-term budgetary framework index (MTBF), but with a significantly shorter time series (2006-2019). However, the regressions have not proved that the effect of MTBF in fiscal consolidation could be categorized by the forms of fiscal governance. Contrary to expectations, between 2006 and 2019, the delegation states achieved slightly higher average MTBF indices than those in contract states. The average values between these two groups differed very little, especially as of 2011 (i.e. the year of adoption of the Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States). Furthermore, delegation states had a higher median of MTBF in 2008, 2009, 2012 and 2013. These findings altogether cast doubts on the higher significance of medium-term budgetary frameworks in contract states.

Conclusion

This paper has identified broadly the same fiscal governance forms in EU countries as those confirmed in the first decade of this millennium. Having considered several characteristics of forming the government (including electoral system characteristics, the average number of government parties, change of governing parties, and ideological differences), these forms have been identified as follows: contract forms (Belgium, Czechia, Bulgaria, Finland, Croatia, Luxembourg, Ireland, Poland, Italy, Lithuania, Estonia, Latvia, the Netherlands, Romania, Slovakia and Slovenia), delegation forms (Austria, Germany, Spain, the United Kingdom, Malta, Portugal, Cyprus, France, Hungary and Greece), and mixed forms (Denmark and Sweden). The theoretic assumptions regarding the contract and delegation approach have been confirmed to a certain extent: contract states have performed better in terms of multiannual planning (namely in expenditure aggregate coverage and commitment nature of the multiannual expenditure frameworks), setting expenditure ceilings and constraints set by numerical fiscal rules. Delegation states aim at a more prominent role of the finance minister in resolving budgetary disputes between ministries. Both forms show rather mixed performance in the legislative budget negotiations: before 2018, the parliaments in delegation states had limited amendment power regarding the draft budget in comparison to the contract states. Compared to delegation states, voting the budget as a way of expressing confidence to the government is rather typical in the contract states. On the other hand, delegation states shifted towards higher centralization than contract states when it comes to voting on the total expenditure first before proceeding to a vote on budget chapters. Regarding the flexibility of budgeting after legislative approval, convergence between contract and delegation forms of governance has been observed. Regarding impacts on fiscal outcomes, numerical fiscal rules were successful in constraining the discretionary behaviour of fiscal policies from 1995 to 2019. This aspect is more prominent in delegation states. However, categorization between contract and delegation states has not been proven, regarding the successful impact of medium-term budgetary frameworks on fiscal discipline. As expected, the effect of the economic and electoral cycle and government's ideological differences appear evident in the delegation states rather than in the contract states. As for all EU countries, highly populated countries may be less prone to avoiding reputational costs of non-compliance with EU fiscal rules.

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