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The perfect finance minister: Whom to appoint as finance minister to balance the budget

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ABSTRACT

The role and influence of the finance minister within the cabinet are discussed with increasing prominence in the theoretical literature on the political economy of budget deficits. It is generally assumed that the spending ministers can enhance their reputation purely with new or more extensive expenditure programs, whereas it is the sole interest of the finance minister to balance the budget. Using a dynamic panel model to study the development of public deficits, we test several personal characteristics of the finance ministers that could influence budgetary performance in the German states between 1960 and 2009. Her professional background, i.e., her field experience, seems to affect budget deficits but neither her individual preferences nor her education does. During times of fiscal stress, our results can guide prime ministers in the nomination of finance ministers in order to assure sound budgeting.

1. Introduction

A benevolent dictator or a welfare-maximizing government would choose the optimal level of debt to finance public expenditures. Thus in reality, politicians face many incentives to leave the path of welfare-maximizing indebtedness. One reason is that the optimal level of debt is not accurately measurable. The debt crisis in European countries and in the United States has triggered a new debate on the reasons for excessive budget deficits and public debt. Besides general economic circumstances, much of the discussion focuses on the institutional and political factors that cause poor fiscal performance. Theories on political business cycles, partisan behavior, and weak governments try to explain the emergence of excessive deficits (e.g., Alesina et al., 1998; Persson and Tabellini, 1999; Rogoff and Sibert, 1988; Alesina, 1988; Roubini and Sachs, 1989b).

Some researchers include the extent of influence the finance minister has within the cabinet in their analysis. Compared to spending ministers who represent only the interests of their own ministries, the finance minister is the most crucial cabinet member with respect to the deficit. She is the only minister with an overall responsibility for the budget. Therefore, the strength of the finance minister might have an influence on fiscal performance. As factors strengthening the minister of finance, the literature examines her procedural rights (von Hagen and Harden, 1995; Hallerberg et al., 2007), her relationship with the prime minister (Jochimsen and Nuscheler, 2011) and the number of spending ministers in opposition to her (von Hagen and Harden, 1995; Kontopoulos and Perotti, 1999; Volkerink and de Haan, 2001).[1] Somewhat surprisingly, however, the individual characteristics of the finance minister, such as

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[1] Thomasius (2013) reviews the literature in his doctoral dissertation.

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personal career planning, educational background and professional experience as well as gender and parenthood, are as yet unexplored.

However, the relevance of the individual characteristics of political decision makers on economic outcomes has been analyzed in related areas.[2] Persson and Zhuravskaya (2011) analyze the influence of the background of provincial leaders on local public policy in China. They find that politicians who built up their career within the region they govern provide more local public goods. A study on municipalities in the German state of Bavaria by Freier and Thomasius (2012) shows that experienced mayors decrease local public debt, lower expenditures and reduce local taxes after their reelection. They find no effect on local public finances for the educational background of the mayors. Dreher et al. (2009) investigate the influence of the educational and professional backgrounds of the head of government on the implementation of market-liberalizing reforms. They find that the professional background matters. Congleton and Zhang (2009) use a similar approach and analyze the influence of U.S. presidents on economic growth. Their results indicate that higher levels of education and the specific professional experiences of a president substantially increase economic growth.

Furthermore, some researchers concentrate on the impact of women on economic policy. Chattopadhyay and Duflo (2004) as well as Svaleryd (2009) analyze the influence of female representation in local councils on local public expenditure structures. Both find that a high representation share of women goes along with higher spending in areas related to women's needs.

In the field of monetary policy, scholars started discussing individual characteristics of decision makers in the early 1990s. Of particular interest is how the voting behavior in the Federal Open Market Committee and the resulting U.S. inflation rate are affected by the educational and professional background of the committee's members (cf. Chappell et al. (1995)). In the first international study, Göhlmann and Vaubel (2007) find strong evidence that the inflation preferences of members of the central bank council depend on their education and professional experiences. Related studies by Farvaque et al. (2009, 2011) support these results on the relevance of professional experience.

Other scholars investigate how the individual characteristics of decision makers affect corporate performance. Hau and Thum (2009), for example, study the influence of supervisory board members on the profitability of Germany's largest banks. They measure competence based on educational attainments and professional experience in business or finance and find the latter to be relevant, but not the former. Bertrand and Schoar (2003) examine the impact of the CEO and show that her educational background, her age, and her tenure are substantially relevant for several corporate decisions on investments, cash holdings, or the debt leverage. In a related study, Benmelech and Frydman (2012) demonstrate that CEOs with military experience differ in their decisions regarding investments, fraudulent activity and corporate performance especially during industry downturns.

Results are rather controversial when the gender of corporate decision makers is taken into account. Carter et al. (2003), for example, show that the firm value increases relative to a higher share of female executives in the top management. Others, such as Adams and Ferreira (2009), find a negative relation between the share of female directors and both the firm value and return on assets.[3]

This article is a first step to address the personal characteristics of a political decision maker in the field of public finance. With a new data set that includes biographical information on the ministers of finance in German federal states, we test several hypotheses derived from existing theories on the political economy of budget deficits. The new data set comprises information on the educational, the professional, and the political background as well as on gender and parenthood of all ministers of finance in the former West German states from 1960 to 2009. We find that the personal characteristics of finance ministers do influence fiscal performance. Our main finding is that the professional experience of the finance minister prior to her nomination affects public deficits. Finance ministers who gained financial expertise, e.g., in the financial business sector, achieve significantly lower deficits than all others. We do not find evidence that her education affects the deficit in any way. Apparently, it does not matter if the finance minister has a university degree or which subject she studied. Furthermore, we find that neither the finance minister's gender nor the existence of children or her age affects public deficits. However, the strength of the finance minister within the cabinet increases with her tenure. The longer she is in office the lower annual deficits are. In coalition governments the finance minister's influence is even stronger if she and the prime minister belong to the same party. However, we do not find support for the partisan theory, i.e., politically left finance ministers do not incur higher deficits than politically right ones.

We employ various dynamic panel estimation methods and our main results are robust. Our findings are relevant for the design of democratic institutions, too. Perhaps the nomination process of party candidates has to be reconsidered. So far, professional experience is not the most important selection criterion. This opens up room for further analyses.

The article consists of five sections. The following section briefly discusses Germany's political and institutional background. In section three, we derive our hypotheses from a review of the literature. Thereby, we concentrate on the literature on the weak government hypothesis that explains fiscal performance. The fourth section introduces our data set and also presents the estimation models and the results. The final section provides concluding remarks and some fiscal policy suggestions.

2. Institutional setting

2.1. Germany's federal design and political parties

The 'Federal Republic of Germany' (FRG) is a federal state consisting of three levels of government, namely the federal level (*Bund*), 16 states (*Länder*), and about 11,340 local authorities (*Gemeinden*). Germany has only had 16 states since 1990: 10 former

[2] Goemans (2008) uses a different approach and investigates the exit modes of political decision makers. He shows that potential future exit modes affect actual policy decisions.

[3] Adams and Ferreira (2009) provide an extensive literature review.