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The economic effects of constitutional budget institutions

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ABSTRACT

There is a well-established literature analyzing the effects of fiscal institutions on fiscal policy variables such as budget deficits or accumulated government debt. We combine this literature with the emerging field of positive constitutional economics, which deals with the economic effects of constitutional rules. The paper addresses three questions: (1) Do budget provisions that are explicitly spelled out in a country's constitution have any significant effect on fiscal policy? (2) Does the transparency, or lack thereof, of the budget process have any significant effect on fiscal policy? and (3) Do these two variables have an impact on other variables such as government effectiveness and productivity? We find that constitutionally entrenched spending limits are correlated with lower total government expenditure and that the transparency of a nation's budget is correlated with higher government effectiveness as well as lower corruption. If anything, the deficit limits entrenched in the Maastricht Treaty are correlated with higher, rather than lower, overall government expenditure.

1. Introduction

Democratic governments are subject to a deficit bias. For various reasons, they are tempted to incur too much deficit. Some constitutional economists argue that constitutionally entrenched spending limits are an adequate means of correcting this bias (e.g., Buchanan and Wagner, 1977). With the Maastricht Treaty, Europe started a huge experiment with entrenched budget rules, setting maximum levels for both current deficits and aggregate debt. However, quite a few other countries had already experimented with entrenched budget rules prior to enactment of the treaty. This paper is the first to systematically analyze the effects of entrenched spending limits on a world-wide scale.

If existing spending limits are not in the (short-term) interest of politicians, politicians may simply ignore them. Spending limits, in other words, are not self-enforcing. Compliance with constitutional deficit rules is likely only if noncompliance is heavily sanctioned. In democracies, it is primarily the voters who can sanction deficit-making governments by refusing to reelect them. We argue that voters having readily available information about the spending behavior of government is a necessary precondition for spending limits to have any actual constraining effect. This is why we do not analyze the effects of constitutional spending limits in isolation but in conjunction with the amount of information publicly available regarding the budget. We call this *transparency*.

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Persson and Tabellini (2003) find that a number of constitutional rules are systematically correlated with low fiscal discipline: for example, if parliamentary government is combined with proportional representation, they find that budget deficits are a stunning 10% of GDP higher than when presidential government is combined with majority rule. Blume et al. (2009b) find that countries with mandatory referendums experience less government spending, whereas countries allowing for initiatives at the nation-state level experience more. In this paper, we ask whether constitutional spending limits can counteract some of these effects.

We find that constitutional spending limits are correlated with lower total government expenditure. Further, they have a mitigating effect on corruption. The spending limits introduced by the Maastricht Treaty, however, have no significant effect on total government expenditure or on governance indicators. If anything, Maastricht countries experience higher levels of total government expenditure. Higher levels of budget transparency have no significant effect on expenditure, but are connected with higher government effectiveness and less corruption.

The rest of the paper is organized as follows: Section 2 briefly surveys the available empirical evidence and Section 3 deals with possible transmission channels through which budget institutions could have an impact on economic outcomes. Section 4 describes the data and our estimation approach. Section 5 contains the actual estimates and offers some possible interpretations. Section 6 concludes.

2. Empirical evidence

Budget rules have been defined as “all the rules and regulations according to which budgets are drafted, approved, and implemented” (Alesina and Perotti, 1999, p. 14). It is helpful to distinguish between substantive rules on the one hand, and procedural ones on the other. Substantive rules constrain the behavior of governments by setting upper limits to deficits; these are often defined as a share of current GDP. Limits can also be based on the level of total debt (instead of current deficit). Alternatively, it could be proclaimed that the deficit must not exceed total investment (as in Germany), that it must be sustainable in the long run (Colombia), and so forth.[1] Procedural rules, on the other hand, deal with the procedures for generating and implementing the budget, i.e., agenda-setting, negotiating, monitoring, and—possibly—sanctioning.

The substantive rules we are primarily interested in are rules that limit the deficits a government is legally entitled to incur and that are entrenched in a country's constitution. We call these “constitutional deficit rules” (CDR). The procedural rules we are primarily interested in are rules that are commands obliging the government to publish specified information about its budget. We call these “transparency rules” (TR).

Almost all empirical studies analyze the effects of budget institutions within federally organized countries or conduct cross-country assessments. In organizing a short survey of the empirical evidence, it thus makes sense to distinguish two dimensions: that between substantial and procedural institutions and that between within-country and cross-country studies. In presenting the available evidence, we broadly follow these distinctions.

Kiewiet and Szakaly (1996) ask whether debt limits contained in the constitutions of the U.S. states affect total state indebtedness. Their work is based on a panel of 49 U.S. states and annual data from 1961 to 1990. They find that some institutions work, while others do not: only one institution is highly negatively correlated with indebtedness, namely, the requirement that the debt be approved by popular referendum. They find some evidence in favor of the hypothesis that the introduction of constitutional limits on borrowing induces attempts to circumvent such rules (in their case, to shift from guaranteed to nonguaranteed debt), and also that some devolution of debts can be observed, in the sense that lower debt at the state level is accompanied by higher debt at the communal level.

Bohn and Inman use a panel of 47 U.S. states for the period from 1970 to 1991 and reach four conclusions (1996, p. 64): “First, balanced-budget constraints that apply to an audited, end-of-year fiscal balance are significantly more effective than constraints requiring only a beginning-of-the-year balance. Second, all state balanced-budget rules are ultimately enforced by a state's supreme court. Those states whose supreme court justices are directly elected by the citizens have ‘stronger’ constraints (i.e., lead to larger average surpluses) than those states whose supreme court justices are direct political appointments of the governor or legislature. Third, there is tentative evidence that constraints grounded in the state's constitution are more effective than constraints based upon statutory provisions. Fourth, and finally, budget surpluses in strong balance-rule states are slightly less responsive to cyclical swings in income and unemployment than are surpluses in states with weak requirements.” Hence, with regard to the United States, both Kiewiet and Szakaly and Bohn and Inman find deficit rules to have some significant impact.

More recently, Primo (2006) shows theoretically that in the presence of exogenously enforceable spending limits, government spending will be lower than in the absence of such limits. Drawing on the period from 1969 to 2000 and looking at 47 of the 50 U.S. states, he not only confirms this conjecture, but also finds that conservative governments spend more than liberal ones when spending limits are in place.

In their study of Swiss cantons, Feld and Kirchgässner (2001) investigate whether explicit statutory fiscal restraints, which are found in only five of the 26 cantons, have any fiscal effect. Drawing on a panel from 1986 to 1997, they find that these restraints have a positive effect on cantonal revenue and a negative one on public expenditure, but neither of these effects is statistically significant. Yet, if the sum of both aspects is analyzed, the restrictions appear to be having effects: cantons with such restrictions have significantly lower deficits and debts.

[1] The IMF (2009) proposes to distinguish between four types of fiscal rules, namely (1) budget balance rules, (2) debt rules, (3) expenditure rules and (4) revenue rules.