On May 2, 1998, the Council of Ministers of the European Union decided that fourteen of fifteen countries could join a new common currency, the euro, upon its introduction seven months later. The council based its decision largely on the budget performance of the individual states. Almost seven years earlier, the Treaty of Maastricht had established a set of economic criteria that countries would have to fulfill if they wanted to circulate the euro. These criteria included an expectation that budget deficits be below 3% of their Gross Domestic Product (GDP). Why did countries in the European Union (EU) succeed in getting their budget deficits below this threshold? A look at the fiscal performance of member states before 1997 indicates why this question is important. During the period 1973–91, European Union countries had had varying levels of success in maintaining the fiscal discipline most had enjoyed prior to the breakup of the Bretton Woods system. The United Kingdom and France had relatively low deficit and debt levels, whereas others, such as Belgium, Italy, and Greece, suffered chronic deficits. The convergence in budget performance that occurred in the mid-1990s was remarkable—all the member states but Greece had brought their annual deficits below 3% of GDP by 1997, and the following year Greece succeeded in doing so as well.

Domestic Budgets in a United Europe examines why this convergence occurred. The obvious answer is that countries wanted to participate in Economic and Monetary Union (EMU), and the Treaty of Maastricht required deficits below 3% of GDP in order for states to qualify. Yet this answer by itself is unsatisfactory. It does not explain why states that previously had run chronic deficits even in good economic times were suddenly able to develop a fiscal backbone. It also does not indicate how states made the transition to fiscal austerity or, if they had maintained relatively tight fiscal policy in the past, whether the Maastricht treaty had any impact on their practice. Important questions
remain. What role did forces external to the country, such as world markets, the European Commission, and pressure from other European Union states, play? Did states initiate fundamental reforms in their budget-making process, or did they reach the targets without reforms to domestic institutions? Were the cuts in deficits real, or, as some commentators suggest, did states rely mostly on accounting tricks to qualify?

Answers to these questions are crucial for several reasons. Twelve of fifteen member states currently participate in what is known technically as “Stage Three of Economic and Monetary Union.” They have adopted a common currency, the euro, and they have delegated the setting of their monetary policies to a newly established central bank in Frankfurt. The European Central Bank has a mandate to maintain price stability in the euro-zone. This delegation, therefore, removes one of the two main macroeconomic tools available to national policy makers. An understanding of how member states made fiscal policy in the run-up to the common currency allows one to evaluate how they use the only policy tool remaining at their disposal today.

One can also consider whether the European cases provide lessons for other countries that experience deficit and debt problems. Finally, and more broadly, budgets lie at the very heart of politics. The most important decisions governments make in most years concern the budget. Budgets set the government’s priorities into law. They determine what groups in society will receive public funding and what groups in society will pay for them. If Maastricht indeed changed the way that European countries make budgets, it also changed domestic politics. An understanding of the budget process is crucial to an understanding of politics. A book about the seemingly mundane topic of “fiscal policy” is by definition political to its core.

In this book I develop and apply an institutional approach to explain the convergence of budget policy within the European Union. Although changes in deficits are most obvious in the 1990s, beginning the analysis in the year of the Maastricht treaty, 1991, is too late to capture the changes that occurred in budget institutions in some EU states. Therefore, I focus the study on the period from 1973 to 2000. I argue that budget performance converged because states either introduced or maintained certain fiscal institutions to keep deficits in check. In some countries the Maastricht framework encouraged these reforms, but without institutional reforms there would have been no convergence. Domestic Budgets addresses what reforms states made and why they made them.

**Political Economy of Europe**

*Domestic Budgets in a United Europe* is firmly in the political economy tradition. It seeks to explain fiscal policy formation in the fifteen countries
that composed the European Union in 1999, the year that the euro was introduced. Although political economy per se has existed at least since Adam Smith and Karl Marx, political economy done explicitly by political scientists with a focus on Europe has developed relatively recently. Before the 1990s, much of the work on the political economy of Western Europe focused on the development of the welfare state. The neocorporatist literature considered the interplay among unions, employer groups, and government in shaping the policy packages that defined the welfare state (Schmitter 1977; Lehmbruch and Schmitter 1982). Katzenstein (1985) and Cameron (1978) identified the important role economic openness played in structuring the strategies that small states pursued in order to survive in a world where they had heavy exposure to the vagaries of world markets. Esping-Andersen (1990) wrote about the distinctions among different welfare states.

There were exceptions in the literature that focused more broadly on economic policy (Hall 1986 and Scharpf 1991 are representative), but the welfare state was often the critical dependent variable.

The welfare state literature remains important, but the political economy of Europe literature has, since the 1980s, become more varied. Institutions such as central banks and policy areas such as monetary policy are increasingly objects of study (Cukierman 1992; Goodman 1992; Bernhard 1998, 2002; Iversen 1999). One of the latest waves of scholarship focuses on macro-policy, more broadly defined (Boix 2000, 2001; Franzese 2002; Clark 2003).

In the area of research on the European Union, there is a growing, and increasingly sophisticated, literature that examines the political economy of European integration. By far the most-covered topic is the Economic and Monetary Union. The focus is often on explaining why European Union countries agreed to EMU in the form it was written into the Treaty of Maastricht in December 1991. The varied explanations include the role of monetarist ideas (McNamara 1998), epistemic communities (Verdun 1999), interest groups that care about potential trade and investment benefits (Frieden 2002), the member states (Moravcsik 1998; Garrett 2001; Kaelberer 2001), the member states plus additional actors such as the European Commission (Dyson and Featherstone 1999; Ross 1995), and American intransigence on exchange rate policy (Henning 1998).


2. A book that was ahead of its time was Crisis and Choice in European Social Democracy (Scharpf 1991), which was published originally in German in 1987. In it Scharpf examines why four states chose a given set of macroeconomic policies in response to the economic crisis Europe faced after the collapse of the Bretton Woods system and the first oil shock.

3. The twelve countries that signed the Treaty of Maastricht were all members of the European Community rather than the European Union, which became the official name only in 1993; but to avoid confusion and following convention in other works I call this organization the “European Union” throughout.
In comparison to this literature on the origins of EMU, there is very little work on why countries met the macroeconomic goals they set for themselves at Maastricht. The work that does exist usually considers individual countries or does not consider explicitly the effects of Maastricht on the making of budgets. Moreover, with few exceptions, the work concentrates on the performance of the large countries. There has been no book-length treatment of how, and most importantly why, all countries but Greece qualified for Economic and Monetary Union. There are, however, several partial explanations that I will now discuss in turn. In each case I explain why the given argument is not a satisfactory explanation for the changes in fiscal policy in EU countries.

**Political Economy of Fiscal Policy under EMU**

One common argument is that EU member states qualified for EMU by relying on a series of accounting maneuvers. States did not really make changes to their budgets, so there is nothing to explain. Dafflon and Rossi (1999), for example, discuss different “tricks” employed in four countries during 1995–97. Melloan (1997, 17, as cited in Dafflon and Rossi 1999, 63) generalizes the argument to the entire Union when he states that “it is uncertain that any country will qualify with honest accounting.” If states simply relied on accounting tricks, then they made few, or no, changes to the way they made budgets. As Willett (1999b, 61) notes in his discussion of the EU’s fiscal policy framework, “The problem is not that the Maastricht and Stability Pact [the Stability and Growth Pact, which set deficit targets of no more than 3% of GDP] criteria were wrongheaded, but rather that the opportunity to piggyback domestic budgetary reforms on the EMU project has borne so little fruit.”

The case studies in this book will provide ample evidence that states did make changes to their budget processes. The point is not that all states made changes in the mid-1990s but rather that the states that needed to make changes mostly did so. (Portugal is the most glaring exception.) Technically speaking, “tricks” do explain why some countries just managed to get their deficits under 3%; some states, and in particular the four states that Dafflon and Rossi (1999) identify, did use several one-off measures that assured that they were able to get their deficits below the critical deficit reference point. Yet these measures cannot explain the general change in budgetary policy. If the tricks were the main story, one would expect that deficit levels would

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5. There have, however, been some excellent works on the macroeconomics of EMU written by economists that consider fiscal policy. See especially DeGrauwe 2000 and Eijffinger and De Haan 2000.
rise again after 1997, once countries had qualified for EMU. There should be little convergence in budget performance. States should have had fairly high budget deficits in the early 1990s and moved to low deficits in 1997, and then deficits should have gone back up after 1997. Budget performance of EU member states during 1991–2002, in fact, varied from country to country; some had high deficits in the early 1990s and some had low deficits (fig. 1.1). There is indeed a convergence toward 1997, but that convergence continues after 1997, while the median moves to budget balance. Although the accounting tricks argument can explain some movement in 1996–97, it cannot explain why there was divergence in the early 1990s nor why the convergence continued after Stage Three of EMU began.

A more political argument concerns the role of partisanship. The political left is traditionally identified with a preference for employment over inflation, while the reverse is true for the political right (Hibbs 1977). One could argue that left-wing governments are more tolerant of budget deficits than right-wing governments. Oatley (1999, 1005) combines this argument with the Mundell-Fleming model to argue that left governments run budget deficits...
when they have fixed exchange rates and open capital. In his study of Organisation for Economic Cooperation and Development (OECD) countries (generally those that are industrialized) during the period 1968–94, he notes that “throughout the period analyzed, leftist governments offered lower real interest rates and ran larger deficits than rightist governments” (1005). Empirical evidence for the partisanship thesis is nevertheless weak. Clark and Hallerberg (2000) reexamined the Oatley hypothesis for both OECD and EU countries during the period 1981–92 and could find no partisan effects. Clark (2003) also found no evidence for partisan effects on fiscal policy. Using regression techniques, I examined the argument for the fifteen members of the European Union (the EU-15) over the period 1980–97 and again found no evidence of a partisan effect (chapter 2). There may be noticeable differences across parties in how money is spent, but there is no clear difference in outcomes relating to the size of deficits.\textsuperscript{6}

Another explanation of the convergence centers on the adoption of a fixed exchange rate. In 1979, a subset of member states formed the European Monetary System (EMS), which required that states maintain their exchange rates within a band. Although there were regular devaluations in the 1980s, the EMS was generally considered a success, and the member countries agreed to narrow the bands in 1988. The United Kingdom, the principal large state that had not joined in 1979, became a member in 1990. The EMS crisis in 1992, which pushed the British pound, the Italian lira, and the Spanish peseta out of EMS, and the pressure on the French franc a year later that led to a widening of the band for France, together left Denmark, the Benelux countries, and Germany as the only remaining “hard” currencies in the system. Maastricht required countries to return to the EMS fold at least two years before joining the common currency. Did the adoption of fixed exchange rates under EMS lead to increased fiscal discipline? There is both empirical evidence for this argument and a more general theoretical rationale. In a study of OECD countries during the period 1973–93, Garrett (2000) found that states with fixed exchange rates and open capital mobility maintained lower budget deficits than states with floating rates. In summarizing the conventional wisdom on why this result is expected, Garrett (2000, 163) notes that “the reasoning is straightforward. Capital mobility impels countries to fix their exchange rates to ward off financial speculation. But in so doing, national governments are also forced to give in to the markets and significantly reduce their fiscal activism. They must cut budget deficits.”\textsuperscript{7}

\textsuperscript{6} However, Bräuninger and Hallerberg (2003) could not find partisan effects even when looking at the composition of spending.

\textsuperscript{7} It should be noted that Garrett (2000) attacks the thrust of this conventional wisdom and adds that the effects of fiscal policy on trade competitiveness also should be added to explain his empirical result.
There are two general problems with this argument. The first is empirical. There is no empirical evidence of a fixed exchange rate effect for the EU countries. Anecdotal evidence from the case studies in this volume explains this finding. While the Netherlands got its fiscal house in order during its EMS membership in the 1980s, its southern fellow EMS member, Belgium, did not. Another EMS member further to the south, Italy, experienced a doubling of its gross debt burden to more than 120% of GDP during its EMS membership.

The second problem with the fixed exchange rate argument is more theoretical. The basic Mundell-Fleming model from macroeconomics provides a reason to be suspicious about the fiscal benefits of fixing an exchange rate (Mundell 1963; Fleming 1962). In the presence of capital mobility, which was likely high in Europe by the mid-1980s at the latest (Hallerberg and Clark 1997), a fixed exchange rate makes fiscal policy a more effective tool to influence the macroeconomy. A series of works on countries in the OECD, the EU, Eastern Europe, and Latin America indicates that countries with fixed exchange rates and open capital mobility tend to use deficit spending before elections as a way to influence the outcome, while countries with flexible exchange rates do not (Clark and Hallerberg 2000; Hallerberg, Vinhas de Souza, and Clark 2002; Clark 2003; Clark, Hallerberg, and Hiroi 2003). Willett (2001) emphasizes the time inconsistency that develops when countries use a fixed exchange rate. The benefits for more effective fiscal policy accrue immediately, while the possible costs are only felt later. Moreover, when a fixed exchange rate requires adjustment, the government feels the costs immediately while the benefits of the change in policy accrue over time. Taking this research all together, it is clear that a fixed exchange rate is not a fiscal panacea. Willett (2001) concludes (as I do) that the sources of fiscal discipline need to be internal to be effective.

Yet, in order to know for sure that external pressure does not explain the change in budget policy, we must evaluate two further arguments. The first is that markets made states adjust. Some authors argue that, in a world of greater capital mobility, it is more difficult for states to run budget deficits because markets will punish lax states (Garrett and Lange 1991; Simmons 1999; Oatley 1999 provides contrary evidence). Countries with large debt burdens may have been particularly sensitive to market sentiment. Capital might have dried up in states such as Belgium and Italy if they had remained outside EMU and outside the new “core” of the EU. The financial penalty for missing the euro boat could have been severe in both counties. As an analyst for ABM AMRO Bank told the Independent (U.K.) in 1997 when commenting on Italy, “There is no middle ground here. Either Italy makes it and Italian bonds converge towards German bonds, or Italy doesn’t and bonds go stratospheric. It’s a binary game.”

Each case study chapter of *Domestic Budgets* evaluates the extent to which market pressure led to changes in budget policy. Yet, even without the case studies, there is reason to believe that, while market pressure can increase the costs of certain budget policies, these costs are not prohibitive. Mosley (2000) examined the determinants of interest rates on government bonds in fifteen developed democracies during the period 1981–95. She found that every 1% of GDP decrease in the budget deficit reduces the interest rate on ten-year government bonds by 0.05%. A move from 6% of GDP to the Maastricht level of 3%, for example, would lower the interest rate 0.15%, or fifteen basis points. When she restricted her analysis to the 1990s, the period where there could be market effects that complemented “Maastricht” effects, the results did not change substantively. The direct evidence that market pressure forced states to get their budgets in order during the post-Maastricht period is also unconvincing. The clear outlier in the size of the debt burden was Italy. Italy had a debt level more than double the Maastricht treaty’s reference value of 60% of GDP in 1995–97, and it provides a nice upper bound for the influence of markets. Favero et al. (2000) calculated that of the 214 basis point reduction between German and Italian forward rates from March 1996 to 1997, only 65 basis points can be attributed to changing perceptions of Italy’s likelihood of EMU participation. Similarly, one can evaluate the interest rate premia that EU member states that have not adopted the euro must pay. Some argue that Denmark may pay up to a 0.5% interest rate premium because it has maintained its own currency (Financial Times, November 27, 1995). The conclusion from these different cases is the same—there is some cost to staying out of the euro, but the cost is relatively low, and, as Denmark has shown, it is one that states can bear.

Another source of possible external pressure is the European Union itself. One blunt version of this argument is that the EU somehow “made” states get their budgets in order. This is implausible; four of fifteen states did not introduce the common currency in 1999, and through 1997 there was genuine uncertainty about how many states would qualify. If the EU simply forced states to join there would have been no uncertainty. A somewhat more subtle, and more common, explanation is that there was some sort of Maastricht effect. Deficits came down because of Maastricht; moreover, if there were domestic fiscal reforms, the EU framework encouraged these changes. To address the role of the European Union, in chapter 3 I introduce the overall fiscal setting at the European level. Every case study will also evaluate the extent to which changes in fiscal policy, and in fiscal institutions, can be traced to Maastricht. To summarize findings later in the book, the case studies do indicate that there is a Maastricht effect, but it is uneven. The treaty largely explains policy change in Portugal; and it explains the timing of the accounting tricks discussed earlier for four additional countries. The
treaty may account for change in some fiscal rules in Greece and Italy. In a majority of countries, however, I cannot find a clear Maastricht effect.

*Domestic Budgets* pays particular attention to the link between institutions and fiscal policy, and there is an important literature that deserves consideration, namely one that considers the role of institutions. This literature can be divided essentially into two types, one that looks at the relationship between political institutions and fiscal outcomes and one that analyzes the effects of fiscal rules on fiscal behavior. (Because all the countries in the European Union are parliamentary democracies, I cover material on presidential systems only if it presents a general model.)

Political institutionalists identify a series of attributes of the political system that affect fiscal policy. Coalition governments are particularly guilty of fiscal irresponsibility, although the reason why coalition governments are poor fiscal stewards varies. One argument contends that coalition governments are poor managers during economic downturns. After a negative economic shock, governments need to make some sort of adjustment, but none of the coalition partners want to bear the costs of the new policy. A “war of attrition” develops in which coalition partners cannot agree on a solution, and deficits, as well as the overall debt burden, increase (Alesina and Drazen 1991; Padovano and Venturi 2001). Extending this logic, recent work contends that increasing the number of cabinet ministers, as well as the number of political parties in government, increases deficits (Kontopolous and Perotti 1999; Volkerink and de Haan 2001). A second reason why coalition governments perform poorly is that they have higher turnover rates. Cabinet ministers who do not expect to remain in power will not care about the future implications of their irresponsible behavior (Roubini and Sachs 1989; Alesina and Tabellini 1990; Alesina and Perotti 1995; Alesina, Roubini, and Cohen 1997). Because these attributes of coalition governments are usually found in countries with proportional representation systems, Persson and Tabellini (2003) generalize to argue that governments with majoritarian electoral systems maintain tighter fiscal discipline than governments formed under plurality electoral systems.

A related, and relevant, literature is the veto-player literature. Conceptually, the number of party actors, or coalition partners, in government can be treated as “veto players.” The number of veto players is equal to the number of actors (usually parties) whose consent is needed for any bill to become law (Tsebelis 1995, 2002). Tsebelis (1995) demonstrated that governments with fewer veto players are able to engender change faster, and with greater depth, than governments with more veto players. The higher the number of veto players, the harder it is for the players to reach agreement to pass laws, and the greater the chance that the status quo will be maintained. Citing empirical evidence provided by Schick (1993), Tsebelis (1995) argues explicitly that increasing the number of veto players increases the size of
budget deficits. In his more recent work, Tsebelis (2002) has changed the focus. Relying on the regression analysis of OECD countries over a thirty-five year period provided by Franzese (2002), he argues that increases in the number of veto players “lock in” certain policies. Countries with more veto players have consistently low, or consistently high, deficits. Tsebelis (1999, 2002) also emphasizes that it is the ideological distance between veto players, rather than the absolute number, that is most critical. The writings of Franzese and Tsebelis are important in that they break from the argument that coalition governments consistently perform less successfully than one-party governments.9

Still others contend that the most important cleavage is not between one-party and multiparty governments but between majority and minority governments. The original article that began much of the debate on the relationship between explicitly political variables and budget discipline, Roubini and Sachs 1989, states that minority governments are the most fiscally irresponsible of all. Edin and Ohlsson (1991), in a reanalysis of the findings of Roubini and Sachs, argue that the coalition effects go away once the regression equation is properly modeled but that the minority effects remain.10 The reasoning is that governments must “buy” votes from opposition parties to get anything passed.

To summarize, the political institutionalists are concerned with how certain institutions in the political system affect fiscal policy. One problem with untangling the effects of each institution individually is that they are often found in distinct packages. Both Lijphart and Powell, in their classifications of majoritarian and consensual (Lijphart 1999) or majoritarian and proportional (Powell 2000) systems, note that proportional representation systems lead to more political parties in parliament, probably more parties in government, and, consequently, more veto players. In contrast, countries with plurality electoral laws or proportional representation with low district magnitudes usually have fewer (or, following Duverger 1954, two) political parties, one-party majority governments, and one-party veto players. This is one reason, in fact, that Persson and Tabellini focus their attention on electoral systems.

Yet the qualification “usually” is not a trivial one. There are countries with a proportional representation system but few parties in parliament. Austria has been one such case during much of its postwar history; and Ireland, with a single transferable vote electoral system that is proportional in practice, is another. Neto and Cox (1997) showed persuasively that there is

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9. See Treisman 2000 for a similar argument about the “locking in” of inflation rates.
10. In De Haan and Sturm’s (1994, 1997) reanalysis of Roubini and Sachs 1989, where they recoded several observations that Roubini and Sachs seem to have gotten wrong the first time, even these minority effects go away and there is no statistically significant relationship between government form and fiscal policy outcome.
an interaction effect between the electoral system and the number of salient cleavages. With plurality, one simply gets something approximating a two-party system. With proportional representation, the number of salient cleavages in society becomes important. A country with only one relevant cleavage that divides votes—which in practice is usually a right-left dimension on economic issues—is likely to have a one-party system even under proportional representation. A country with proportional representation and five relevant cleavages will have more parties. Both Austria and Ireland are European Union countries, and government-type effects can be separated from electoral system effects. This point becomes important when I argue that it is the party system, and not the type of electoral system or government system per se, that is the crucial explanatory variable.

To understand what it is that the party system determines requires an understanding of the institutional literature that examines the fiscal norms and rules that define how governments make their budgets. The “fiscal institutionalists” generally argue that a decentralized policy process leads to weaker fiscal discipline than a centralized one. The cause is what the literature refers to as a common pool resource problem, which arises when policy makers consider the full benefits of additional spending but do not consider the full tax implications.11 In the European parliamentary democracies, the most important decision-making arena is the cabinet, and the common pool resource problem arises in this setting when individual ministers set the budgets for their ministries. The agriculture minister cares most about farmers, for example, while the defense minister worries about the size of the military’s budget.

Centralization is therefore necessary to address this problem, if fiscal discipline is to be maintained; in practice this can take different forms. One of the classic texts on budgeting, Wildavsky’s *Budgeting: A Comparative Theory of the Budget Process* (1975), portrays the finance minister as the “guardian” of the treasury who keeps the spending of “advocates” (or spending ministers) in check. Building on this premise, some argue that the stronger the finance minister in the budget process the more fiscal discipline there will be (von Hagen 1992; von Hagen and Harden 1994; Hahm et al. 1996). In making its recommendations on policy reforms, the Inter-American Development Bank (1997) took this literature to heart. While noting that most Latin American countries have strong finance ministers already, the bank argued that in countries where the finance ministers were not already strong, strengthening them would lead to greater budget discipline.

Although this emphasis on the role of the finance minister is a common one, some argue that there is an alternative approach that can centralize the budget process when the finance minister is weak. The players in the game can negotiate clear spending targets for each ministry at the beginning of

11. I rely on this literature on the common pool resource problem. Chapter 2 provides a formal model of the problem as well as a detailed discussion.
the term of a government. This approach seems to yield the same level of fiscal discipline as that seen in countries with strong finance ministers (von Hagen and Harden 1994; Hallerberg and von Hagen 1999; Hallerberg, Strauch, and von Hagen 2001). Under this construct, the parties are forced to consider the entire tax burden on the potential coalition when they negotiate budgets.

Although the discussion so far has concentrated on decision making in cabinets, fiscal institutionalists also consider the structure of other parts of the budget process. In a classic article, Weingast, Shepsle, and Johnsen (1981) identified the dynamics of a common pool resource problem in a legislature where each legislator worries only about the tax burden on her district but all spending comes from a common pool of funds. Legislators form “log rolls” where they support one another’s spending requests. The way legislators vote on spending determines whether the log rolls happen. Note that if bills for spending in districts were voted on sequentially and separately, Congress members should vote for no bills but their own. Other bills simply increase the tax burden on one’s voters without providing any tangible benefits. Some sort of institutional rule is needed to maintain log rolls in legislatures with many members. Other writers, such as Shepsle and Weingast (1994) and Baron (1991), argue that “closed rules” (simple up or down votes on bills with no possibility of amendment), as well as votes on packages of bills in the form of omnibus bills, allow for log rolls.

Hallerberg and von Hagen (1999) brought the two institutionalist literatures together, relating fiscal rule outcomes to the electoral system in place. Countries with plurality electoral systems, or with proportional representation systems where the district magnitude is low, are more likely to adopt a strong finance minister model, which we call “delegation.” We argue that one-party majority governments, or governments where the parties present themselves to the public as electoral blocs, are most appropriate for a strong finance minister model. In contrast, countries with proportional representation systems with high district magnitudes are most amenable to negotiated fiscal contracts, which we call “commitment.” In our empirical work, we showed that countries either have decentralized budget systems, which we refer to as “fiefdom” governments, because spending ministers run their ministries as their own fiefdoms, or they adopt a form of centralization that is consistent with the prediction. Those countries that have either delegation or commitment systems have better fiscal discipline than countries with a fiefdom system.

I believe our work nicely integrates the two literatures, but it also leaves some important questions unanswered. First, it does not attempt to explain why states move from fiefdom, or the decentralized case, to one of the two institutional solutions to the common pool resource problem. Second, it does not consider explicitly how minority governments may differ from majority governments.
The Making of Domestic Budgets

I build on the Hallerberg and von Hagen (1999) framework in the pages that follow. Consistent with our previous work, I argue that political institutions are highly relevant because they determine the types of fiscal institutions that may centralize the budget process. I take it a step further with the argument that political institutions can also explain why sound fiscal institutions fail to take root. Once this theoretical framework is in place, I then ask how, and whether, Maastricht may have changed the way budgets are made in Europe.

In chapter 2 I present the model that structures the remainder of the book. There are two crucial institutional variables that determine the type of fiscal framework a government can put in place: the party system and the minority/majority dichotomy. The significant aspect of the party system is whether governments that emerge from it are generally unified ideologically or whether there are real ideological differences among coalition partners. There are two situations in which the party system will produce unified governments. The first exists when there are only two effective parties in the system. In the European Union, the United Kingdom is the principal case. The Conservative and Labour Parties are the main political parties, and a government that emerges will have either the Conservatives in power alone or Labour in power alone. Another system that is functionally almost the same is one where parties cluster along the ideological spectrum. The French party system is a good example of such clumping. There have been right governments that brought together the Union pour la Démocratie Française (UDF) and the Rassemblement pour la République (RPR) and left governments that brought together the Socialist Party (SP) and the French Communist Party. The key point is that any government that forms has little or no internal discord based on ideological differences. If there is a one-party government, or if the parties in government are close to one another ideologically, the ministers can delegate the centralization of the budget process to a strong finance minister who can help maintain fiscal discipline. I refer to this type of budget centralization as a delegation form of fiscal governance. The budget process maintains tighter fiscal discipline when the finance minister has a lot of discretion.

The other extreme is a party system where there are several distinct ideologies. The various parties are generally not close to one another ideologically. Coalitions represent a broader ideological spectrum. Finland and the Netherlands are representative cases. When parties diverge ideologically, they are not willing to delegate power to one person—who can come from only one party—to centralize the budget process. An alternative way to centralize the budget process is for the parties to negotiate, and then to commit themselves to detailed fiscal targets for the life of the coalition. These targets,
and the rules to enforce them, compose a fiscal contract. I refer to this form of fiscal governance as *commitment*. Unlike delegation, which relies on the finance minister’s discretion, commitment functions best when there are clear rules. The rules will include certain types of fiscal targets, which can be by ministry or even by agency within ministry. These specific targets reinforce general targets such as deficit and expenditure targets. There are also rules for what to do when unanticipated economic shocks put pressure on the fiscal contract. A contract may mandate a cut in spending in certain ministries if economic growth is lower than forecast, for example, or mandate tax cuts if revenue collections are higher than forecast.

This brings us to our second relevant variable. With a majority government, either delegation or commitment is applicable. Note that both forms of centralization involve decisions at the cabinet level on both the formation and the execution of the budget. Although the legislature formally passes the annual budget, party discipline is high in the parliamentary systems found in Europe, and, if centralization exists, there is little that parliament can do to alter the budget. However, with a minority government, the government needs one or more opposition parties on its side in order to pass the budget. The key again is whether or not the budget process is centralized. If the government must every year “buy” legislators and/or parties in the opposition, the result is then consistent with what Roubini and Sachs (1989) and Edin and Ohlsson (1991) predict, that is, that fiscal discipline will be undermined. An institutional solution is one that mixes both delegation and commitment. At the budget formation stage, a strong finance minister can centralize the process within the government. At the parliamentary stage, the government can then negotiate a fiscal contract with the opposition that includes every dimension of the budget. In this way, the parties consider the full tax implications of their decisions. I call this system a *mixed* form of fiscal governance.

If these options exist for governments to centralize their budget processes, and if the party system and the majority/minority government dichotomies predict specific packages of fiscal rules, why don’t all countries adopt the relevant rules and be done with it? Once again, the key explanatory variable is the party system. Countries need *stable, competitive* party systems. Stability is needed so that the relevant fiscal rules can be institutionalized. Note that the predictions about what types of fiscal institutions are effective differ across the ideal types. Detailed rules on the many dimensions of the budget would needlessly limit the power of the finance minister in a country with a one-party government. Similarly, giving discretion to one central figure is not likely to work under multiparty coalition governments. If the shape of the party system changes greatly from election to election, the relevant packages of fiscal rules will change as well, and will not become institutionalized.

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12. The one exception to this rule is Italy prior to the mid-1990s.
Changing the shape of the party system is not the same thing as changing the government, and indeed the second question concerns party competition. The very heart of the common pool resource problem is that there is a temptation to draw from the common pool to pay for specific goods. If there is no punishment for ignoring the full tax burden, then parties will spend and spend. The punishment ultimately comes from voters who punish irresponsible governments. Voters cannot punish governments if there is not a credible opposition. Fiscal reforms, therefore, will fail when there are uncompetitive party systems. An illustrative case is Italy before the early 1990s. It was impossible to conceive of an Italian government that did not include the Christian Democrats.

**Domestic Budgets and the European Union**

The arguments of *Domestic Budgets* can be traced in schematic fashion (fig. 1.2). Once this theoretical framework is in place, one can reexamine the meaning and the importance of the Maastricht process. In chapter 3 I explain the fiscal policy framework at the European level. Maastricht represents a package of rules and a series of mechanisms to enforce those rules. The process helped the production of budgets in all countries to some extent by increasing budgetary transparency. Eurostat, the European Union’s collector of statistics, now produces harmonized figures for all countries, and it investigates and, on occasion, revises the figures that member states report. Yet, as the case study chapters demonstrate, the Maastricht framework (and later the Stability and Growth Pact) had, and has, an asymmetric effect on member states.
An important issue concerns the adoption of a set of fiscal rules. Maastricht created incentives for countries to reform their fiscal rules. Yet one finds surprisingly little support for the thesis that Maastricht is the reason why EU member states succeeded in reining in their budgets. Maastricht had the greatest impact in the southern European countries. They were countries where the European Union enjoyed strong popular support and where their elites worried about the possibility of becoming a “second-class Europe” if an inner French-German core formed an Economic and Monetary Union on its own. Other countries, however, such as the Scandinavian countries of Finland and Sweden, made reforms in the mid-1990s for reasons that had little to do with Maastricht. Still others revised their fiscal systems before Maastricht was signed. For this reason, one cannot start with the signing of the Treaty of Maastricht in December 1991 to make an argument about the development of fiscal institutions. Indeed, explaining why some states revised their fiscal systems during the economic difficulties of the early 1980s while others did not tells us something about the conditions under which countries reform themselves.

Each of the case study chapters, therefore, covers the period from the two oil crises of the 1970s through the introduction of the euro. During this time several European states confronted growing budget deficits. Some states, such as Denmark and the Netherlands, introduced new fiscal rules that became institutionalized over time. Other states, such as Sweden, suffered similar economic difficulties but did not initially revise their budget institutions. In each chapter, I trace the development of the party system and fiscal rules. I also examine the fiscal performance of each country in terms of the cyclically adjusted budget balance and the overall debt level. The cyclically adjusted budget balance allows the reader to see changes in discretionary policy that are not picked up when the simple budget balance is used. These figures are in general government terms and are based on Maastricht definitions of deficits and debt. For each country, I then determine the relevant participants in the budget process; trace the development of fiscal rules and the development of fiscal policy; and consider the explanations for the changes in policy.

In every case I consider two explicit hypotheses, in addition to the argument about the importance of fiscal rules. First, I try to determine what Maastricht effect, if any, existed as an explanation for fiscal performance. Second, I examine whether market pressures forced states to adopt tighter fiscal policies. In terms of sources, I rely on secondary sources where possible. Materials for the large countries are more readily available than for the small countries. Yet I found during the research process that there was no work that asked the same questions asked here for the same time period. I therefore

13. I was not able to conduct interviews in Vienna. I did, however, make phone calls and correspond via fax and e-mail with individuals in the Austrian National Bank and in the finance ministry.
conducted on-site interviews in the capitals of fourteen of the fifteen member states. The people interviewed were public servants in finance ministries, economics ministries, regional governments, and parliaments. I also checked with academics and journalists who follow fiscal policy. As the reader will soon discover, these interviews were especially helpful in explaining events in countries for which a secondary literature was lacking.

To explain what happened when and why, Domestic Budgets looks at European Union member states according to the shape of their party systems. In chapter 4 I discuss countries that have consistent one-party majority governments, such as the United Kingdom and Greece. They are ideal settings for delegation to a strong finance minister. The United Kingdom adopted the appropriate fiscal institutions, and it serves as the model case for delegation. Greece does not have such a framework in place; it did, however, revise its institutions along delegation lines around 1997. Maastricht played a critical role in encouraging change in Greece. Two other countries, France and Germany, have party systems that pit blocs of parties against each other in elections. Delegation also functions in these cases, although, as the German case will illustrate, the somewhat larger ideological distance between coalition partners as well as the need to get some legislation through an upper chamber of parliament complicates matters and makes delegation less effective than in the United Kingdom.

In chapter 5 I consider countries that have party systems in which parties are not close to one another ideologically. The Netherlands is the ideal case. During the 1970s, it tried to move toward a delegation mode with centralization under Finance Minister Wim Duisenberg. This attempt failed when the parties in government refused to support the finance minister’s austerity measures. In 1982, the liberals (VVD) and the Christian Democrats (CDA) signed the first true “fiscal contracts.” In 1994, after the Christian Democrats lost office, the new coalition tightened the contract. It included detailed spending targets at the subministry level as well as rules for how to adjust the contract if the budget did not perform as expected.

Belgium also had a party system with many opposing parties. All governments had to include parties from the two largest regions in the country, Flanders and Wallonia. Voters, or other parties, could not punish a regional party that overspent. Steps to federalize the country in 1989 and 1993 largely broke this log jam.

Finland illustrates the usefulness of explicit contracts with explicit rules. The country maintained fiscal discipline in the 1980s through essentially informal contracts. When it experienced a sharp economic downturn at the beginning of the 1990s, it introduced several changes to the way it makes budgets that moved the process closer to the commitment ideal.

In chapter 6 I examine two Scandinavian countries, Denmark and Sweden, that traditionally have one large party, the Social Democrats, that forms
a minority government. In Sweden, centralization of the budget process behind the finance minister worked as long as the Communist Party granted the Social Democrats unconditional support from the opposition benches. In the late 1980s, the Communists changed tactics and the Social Democrats had to “buy” votes from moderate parties. Denmark similarly had been dominated by Social Democratic minority governments. It also had fiscal problems in the early 1980s. A minority center-right coalition introduced a series of fiscal reforms in 1982 that institutionalized regular negotiated fiscal “contracts” between the government and one or more opposition parties that covered all dimensions of the budget.

In chapter 7 I focus on Italy. This country experienced a fundamental reorganization of its party system in the early 1990s because of the “Clean Hands” trials that addressed political corruption, the collapse of Communism, and the change of the electoral system from proportional representation to a mixed system. Indeed, Italy moved from an uncompetitive party system, under which the Christian Democrats could not be unelected, to a competitive system composed of two rival blocs of parties. As the theory predicts, the form of fiscal governance changed at almost the same time from a fiefdom form of fiscal governance to a delegation form under a strong treasury minister. Maastricht probably was a sufficient reason for the timing of the tightening of fiscal policy in 1996 and 1997, but the necessary change in political institutions was at the party system level.

In chapter 8 I discuss four countries that have not maintained stable party systems. Austria and Ireland have bounced between systems that supported one-party governments, minority governments, and coalition governments. The reason was the rise of third parties that made it difficult to institutionalize a specific form of fiscal governance. In Ireland, the party system through the late 1980s made one of two forms of government possible—either a multiparty majority party (including Fine Gael, or FG, as one partner) or a minority one-party government (Fianna Fáil, or FF). It was not possible to institutionalize firm fiscal rules because the form of government changed repeatedly. In the early 1990s, however, the party system changed, and only multiparty coalition governments have been likely since then. Fiscal institutions consistent with a commitment form of fiscal governance have recently been introduced and strengthened.

Portugal and Spain have experienced difficulties somewhat similar to those in Ireland. Small parties have been strong enough to block one-party majority governments over significant periods of time. Instead of opting for coalition governments, as is common in Austria, however, the parties chose to form minority governments. There was some centralization of the budget process around the finance minister in Spain, but there was less change in Portugal. In the Iberian countries Maastricht affected the timing of the improvement in fiscal discipline. Spain, where fiscal institutional reforms
were put in place, has, since 1997, performed better than Portugal, where significant reforms were not introduced.

In the conclusion I discuss the implications of the argument for the future of the fiscal framework in Europe. I suggest that the “one size fits all” approach at the European level is flawed. Detailed fiscal rules work well for commitment countries, but they may be counterproductive in delegation countries. It is consistent with this theory that two delegation countries, France and Germany, had difficulties in 2002 in keeping their budget deficits below 3% of GDP. The conclusion also discusses whether the model developed here can be extended to non-European Union countries and its general relevance to the study of comparative political economy. There are some outstanding political science books that consider the design of party systems, electoral systems, and the like as interconnected packages (Lijphart 1999; Powell 2000). The dependent variable in such work is usually an explicitly “political” one, namely effective representation. Domestic Budgets illustrates how such institutional packages extend to fiscal institutions and fiscal outcomes as well. Political stability and party competition are not only values to be preserved in their own right, they also contribute to the institutionalization of fiscal rules that lead to better fiscal performance.
Forms of Fiscal Governance

To understand budgetary outcomes one must understand how budgets are made. There are four ideal types of decision making, which I term “forms of fiscal governance.” To illustrate these ideal forms, I begin with a simple formal model of the budget-making process in parliamentary democracies where the principal decisions on the budget are made in the cabinet. The key premise is that every government faces a common pool resource problem. In practice, the problem permeates decision making. Policy makers, for sound political reasons, do not have an incentive in most cases to consider the implications of their spending decisions on the full tax burden. If policy makers do little to address this problem, then a fiefdom form of governance predominates. Policy makers consider their domains their “fiefdoms,” and they decide spending levels more or less in isolation from one another. There are, however, two “ideal” forms of governance conducive to solving the common pool resource problem, the modes of delegation and commitment.

Delegation involves vesting the finance minister with significant decision-making powers over public monies. Under commitment a group of agents with similar decision-making rights enter an agreement, or a “fiscal contract,” to commit themselves strictly to budgetary norms, that is, targets for budget aggregates set for one or more years. A third form of governance that solves the common pool resource problem, which is found in minority governments only and combines elements of both ideal forms, is the mixed form.

Each of these ways of solving the common pool resource problem has distinct implications for the adoption, and for the effectiveness, of fiscal institutions. In delegation states, the emphasis is on improving the discretion of the finance minister in the budgetary process. One expects formal or informal rules that enhance the position of the finance minister. Moreover, it is likely that there will be spending targets such as caps on personnel costs and explicit mechanisms to deal with open-ended expenditures and the like to make
the budget more manageable for the finance minister. In contrast, in commitment states one expects a range of formal rules to maintain the fiscal contract among the political parties that make the initial agreements. This mode of governance is more rule-based, and one should expect a range of multiannual targets and subtargets, as well as rules to deal with unexpected shocks, so that the initial agreement is not broken. The mixed form of governance has elements of delegation in the budget deliberations that take place within the cabinet and elements of commitment in the “contracts” the government signs with one or more opposition parties in parliament.

To understand why states adopt the form of fiscal governance that they do one must first determine the potential form of fiscal governance. Delegation is unlikely to function when the ideological distance among cabinet members is great, while commitment does function in such a situation. A mixed form of governance exists under minority governments. The underlying party system can allow one to predict which of these forms of fiscal governance is most appropriate for a given country. Delegation can arise where there are two main parties that face each other in elections, or where there are two blocs of parties where the parties in each bloc are close to one another ideologically. Commitment, conversely, arises in countries where political parties are not bunched together and where they traditionally run against one another in elections even if they are in a coalition government. Finally, a mixed form develops in countries where the party system makes majority governments unlikely.

We can then predict the actual form of fiscal governance. Once again, the party system is crucial. An uncompetitive party system does not encourage parties to address the common pool resource problem. Fiefdom is the likely outcome, as cabinet ministers take care of their respective clienteles. An unstable party system also makes it difficult to institutionalize a given form of fiscal governance. A shift from one-party majority governments to multi-party coalition governments and back again does not allow the institutional structure to gel.

The Budget Process

There are three principal stages of the budget process: planning, decision making, and implementation. In reality the stages of the process may overlap, but in an ideal sense we can consider how these stages may differ in different systems. In the planning stage, governments make forecasts about revenues, spending needs, economic growth, and the like. The planning can be detailed and look forward several years. It can also bind the government to certain levels of spending and/or certain levels of revenue unless new legislation is passed to change the budget plan, as the multiannual plan does in Sweden today. The
A Model of Budget Making in Parliamentary Cabinets

Ministry and Party Ideal Budgets

There are three relevant groups in the model of decision making within the cabinet. Spending ministers ($S_1, S_2, \ldots, S_n$) make bids for the level of spending

1. Some authors treat the monitoring of the budget as a separate stage; see, for example, von Hagen 1992 and Hallerberg, Strauch, and von Hagen 2001.

2. The model is based on similar models presented in von Hagen and Harden 1994, Hallerberg and von Hagen 1999, and Hallerberg 2000. Von Hagen and Harden (1994) write about the common pool problem in cabinets. This model does not have parties as actors; it assumes that ministers worry about ministry constituencies only, and it is a one-period game. The Hallerberg and von Hagen (1999) model is multiperiod and considers the effects of the common pool resource problem on the size of deficits. The focus remains on the cabinet, not the party. It also links the type of electoral system with the institutional choice of a solution to the
to be allocated to their ministries. They also spend the budgets allocated to them once they are approved. All spending ministers together form the government (G). A subset of the members of government belong to political parties \( \{ P_1, P_2, \ldots, P_k \} \).

Spending ministers seek full funding for those programs they consider important for reaching their policy goals, and their proposals affect the spending side of the budget. I assume that members of the same political party share the same ideal budgets for each ministry. The variable \( x_{ip}^* \) represents the ideal spending level of party \( P_p \) for ministry \( i \). Ministers also seek to minimize the taxes that their constituencies must pay, and \( m_i \) is the amount of the total tax burden that the minister expects her constituency to bear. This amount can be equal to or less than the level of taxation on the minister’s party constituency, so that \( m_i \leq m_p \). Finally, the minister may benefit simply from having larger budgets, and as a consequence she will request funds that are greater than the minimum needed to reach her policy goals (Niskanen 1971). The degree to which she values additional spending is represented by \( \lambda \). Assuming that the excess burden of taxation is quadratic, the \( ith \) minister will possess the utility function

\[
U_i = \lambda x_i - \frac{\alpha}{2} (x_i - x_{ip}^*)^2 - \frac{m_i}{2} T^2
\]  

(1)

where \( x_i \) is the amount of funding the ministry ultimately receives and \( \alpha \) the relative weight that the minister places on spending concerns. If one assumes that there is a hard budget constraint\(^4\) so that \( T = \sum_{i=1}^{n} x_i \), then the spending minister \( j \) chooses a budget for his ministry that takes the form

\[
b_{ij} = \frac{\lambda + \alpha x_{ip}^* - m_j \sum_{i=1, i\neq j}^{n} x_i}{\alpha + m_j}
\]  

(2)

Now consider an alternative situation in which the spending ministers reflect fully the preferences of their political parties. In this case the ministers consider the effects of total spending and total taxation for party \( P_p \), and they do not value higher spending for their ministry in its own right. The joint utility equation for the party is

\[
\text{common pool resource problem. Hallerberg 2000 develops an extensive form game that stresses the monitoring and punishment aspects of the different ideal types of government. This paper explicitly considers parties as actors. Although the substantive conclusions do not differ significantly from the earlier models, the consideration of parties allows a more explicit comparison with coalition theorists.}

3. This assumption can be relaxed by treating party factions as separate parties in the formal model.

4. Note that this hard budget constraint will be relaxed later in this chapter.
Note that the size of the budget in both equation 2 and equation 4 is dependent on what other ministers choose as their ideal budgets. To determine whether $b_{sj} > b_{pj}$ in practice requires one further step. So that the argument is easy to follow, I assume that the ideal budgets for the political party are the same across ministries so that $x_i^* = x_{i,p}^* = x_{j,p}^* = \ldots = x_{w,p}^*$. I also assume for any ministries $i$ and $j$ that the budgets the ministers ultimately select are the same, such that $b_{ij}^* = b_{ij}^*$. Finally, I assume that ministry constituencies do not overlap such that $m_p = \sum_{i=1}^{n} m_i$ and $m_j = \frac{m_j}{n}$. The solution that is ideal for the party is

$$b_{pj}^* = \frac{\alpha x_{ij}^*}{\alpha + m_p}$$

while the ideal budget for the individual is

$$b_{sj}^* = \frac{\lambda + \alpha x_{ij}^*}{\lambda + \alpha + n m_j} = \frac{\lambda + \alpha x_{ij}^*}{\alpha + m_j}$$

Clearly, $b_{sj}^* > b_{pj}^*$ when the minister does not consider the entire tax burden on the party’s constituency and/or so long as $\lambda > 0$, and this inequality indicates that the budget a given spending minister would like to propose is larger than the party’s optimal budget.

Given the importance of the tax burden to the outcome, how likely is it that ministers will not consider the party’s full budget? Partial consideration of the tax burden is generally the rule for the following reasons: First, ministers are often judged by how well they protect the interests of the constituents of their particular ministry. An agriculture minister may care most about the effects of spending and taxation on farmers, while a labor minister has similar worries about the effects of spending and taxation on workers. In Germany, for example, in the cabinet of Helmut Schmidt, Defense Minister Hans Apel, a working-class Social Democrat from the docks of Hamburg, became such a vociferous advocate for his ministry that he was the only Bundestag member within his party besides his chancellor to support the stationing of American short-range missiles on German territory in the early
1980s. The general point is that where one stands on budget issues within one’s party depends on where one sits at the cabinet table. If cabinet members cared only about the tax burdens on their ministry’s constituencies, then all \( m \) would sum to the total tax burden on the cabinet.\(^5\)

There is some empirical evidence that ministers care only about spending and taxation for their particular ministries. Kontopoulos and Perotti (1999) have found that in a panel of OECD countries for the period 1970–95 the more ministers there were in a given cabinet the higher the level of spending and the higher the budget deficit. This is only one study, of course, but more empirical evidence will be presented in the case study chapters.

A second reason why ministers likely do not consider the full tax burden is that their parties are coalitions of different interests. Leaders within the party generally represent the spectrum of party supporters. In the March 2000 cabinet reshuffle in France, for example, Laurent Fabius as minister of finance represented the more monetarist wing of the Socialist Party, while Martine Aubry remained as a more left-leaning minister of employment. In Germany, Norbert Blüm came from a Christian Democratic Union (CDU) post, yet he was a steady advocate of prolabor policies as labor minister within Helmut Kohl’s cabinet.

The ideological distance between different factions within a political party is not a random phenomenon across countries. This variable is, to some degree, a function of the underlying electoral system. Under proportional representation systems with high district magnitudes, one would expect many political parties with potentially narrow constituencies. In contrast, under a plurality system one expects a two-party system with “big tent” parties that bring together more diverse interests under one party label (Duverger 1954; Katz 1980). Moreover, plurality systems lead members of parties to care about geographically specific interests. As a consequence, Lancaster (1986) has argued that legislators in plurality systems provide more pork barrel projects than legislators in proportional representation systems. Weingast, Shepsle, and Johnsen (1981) similarly have contended that in the American system legislators care only about the spending and the tax burden in their districts.

Assuming that the tax burden is distributed equally across a given country, they assume that the amount of the tax burden a legislator considers in a legislature with \( m \) members is simply \( 1/m \). Because in Europe cabinet members generally come from the legislature, there is reason to believe that they consider only part of the total tax burden.\(^6\)

In sum, if ministers are left alone there are good reasons to believe that they commonly do not consider the full tax burden when they decide the

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5. This logic is the basis for the model in Hallerberg and von Hagen 1999.
6. For a discussion of the relationship among electoral systems, party discipline, and the choice of open or closed rules in European parliaments see Hallerberg 2004; for Latin America, see Hallerberg and Marier 2004.
ideal spending level for their ministries. The shape the budget takes depends on the decision-making process.

**Fiefdom Governance**

How are individual budget bids translated into the total budget? In the fiefdom approach, ministers decide the spending levels for their respective ministries, and the budget process involves simply aggregating the individual budget bids into a total budget. In practice, this model applies when the general cabinet sets the budget and spending ministers can coordinate log rolls with one another that allow them to get actual spending levels that correspond to their spending bids. What the budget ultimately looks like depends crucially upon the number of, and the ideological distance among, parties in government, because of the differences in ideal budgets across parties.

I begin with a one-party government. For simplicity and without loss of generality, I again assume that the ideal budgets for the political party are the same across ministries so that $x_p^* = x_{1p}^* = x_{2p}^* = \ldots = x_{np}^*$. I also assume that the budgets that the ministers ultimately select are the same, such that $b_p^* = b_i^*$. The aggregate level of spending if the ministers receive their ideal budgets is then

$$ B_i = \frac{n\lambda + n\alpha x_p^*}{\alpha + m_p} \quad (7) $$

which is larger than the collectively optimal budget of

$$ B_p = \frac{n\alpha x_p^*}{\alpha + nm_p} \quad (8) $$

The situation under a multiparty government is somewhat more complicated but nevertheless tractable. The model assumes that parties hold different ideal spending preferences for each ministry, which in the model means that the parties have different $x_p^*$. Many coalition theorists assume, in fact, that negotiations concern the distribution of portfolios among parties with different policy preferences (Laver and Shepsle 1996).

To simplify the discussion, consider the case with only two parties in government, party A and party B. Assume as well that party constituencies do not overlap so that $m_p = \sum_{i=1}^{n} m_i$ and $m_i = \frac{m}{n}$, where $m$ is the total tax burden.

7. The model developed by Baron and Ferejohn (1989) remains the most succinct one. In their terminology the cabinets discussed here are merely small legislatures where the number of legislators is equal to the number of cabinet ministers. Their formal model indicates that votes with open rules in small legislatures and a costly delay can lead to universalistic solutions. The “legislators” unanimously agree on the outcome with each legislator receiving her preferred budget.
on the coalition. If one simply adds up the spending requests of the different ministries under the two parties the total budget is

\[ B_{\alpha} = \frac{n\lambda + \alpha \sum_{i=1}^{nA} x_{iA}^* + \alpha \sum_{j=1}^{nB} x_{iB}^*}{\alpha + m} \]  

(9),

and \( n_{\lambda} + n_{\beta} = n \).

If the parties consider the full tax burden on the coalition instead, and if they set the spending levels that maximize their joint utilities (that is, they set the budget figures and not individual ministers so that \( \lambda = 0 \)), then the budget takes the form

\[ B_{\beta} = \frac{\alpha \sum_{i=1}^{nA} x_{iA}^* + \alpha \sum_{j=1}^{nB} x_{iB}^*}{\alpha + mn} \]  

(10)

Once again, spending under the fiefdom approach is higher than if the parties had jointly set the budgets.

The general problem is, therefore, the same under both one-party and multiparty coalition governments. When decision making is decentralized, the players suffer from a common pool resource problem. The greater the fragmentation of the cabinet, the smaller the tax burden a given minister considers and the larger the common pool resource problem. All of the ministries suffer from the additional spending by other ministers that comes from the same tax revenue pot. The utility equations for both individual ministers (equation 1) and political parties (equation 3) indicate that both types of actors suffer utility losses because of higher spending by ministers who do not consider the full tax burden. This common pool resource problem is, therefore, also a collective action problem. All actors would be better off if they considered the entire tax burden rather than considering only the tax burden on their ministry.\(^8\)

One should note that, unlike in the forms of governance that follow, there is no internal logic that connects the institutions present at the three stages of the budget process to the fiefdom model. Instead, it is a matter of identifying whether fiefdom is present at one or more stages of the process. Concerning the decision-making stage, one looks for situations in which the party that receives a given portfolio determines the policies of the ministry without interference from other coalition partners. If the minister does exactly what the party wants, then the budget decision reflects consideration of the tax burden.

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\(^8\) This model is potentially applicable to parliaments, as well, if parliaments can change the budget and parliamentarians can set the budget figures for areas of their expertise as they choose. The question here concerns the relevant actors. Even in fiefdom states there is usually some party discipline, and majority governments usually pass their cabinet's budget proposals. Parliament does play a more crucial role in minority governments, and the fiefdom model appears in cases in which the minority government must buy votes from opposition parties.
on the minister’s party only, not on the entire coalition. If the ministers determine their budgets more or less autonomously, then the budget outcome for a particular ministry matches that given in equation 9. One way to facilitate this outcome is to have the full cabinet make decisions on the budget. This allows the ministers to log roll their preferred ministerial budgets. One also expects little or no centralization of the budget process in the cabinet. The budget outcome is simply an aggregation of individual budget bids. The finance minister serves as a glorified accountant who may audit books and keep track of the budget figures. She has no say on the final budget outcome.

A likely symptom of fiefdom is that budget planning into the future has little or no practical importance, and indeed may be totally absent. There is no functional need for fiscal planning, because ministers are likely to ignore whatever planning does occur.

This form of fiscal governance can exist at the implementation stage if ministers can easily adjust their spending levels without regard to the effects of their decisions on the total tax burden. For example, it was routine in Italy under the five parties in government, known as the *pentapartito*, for parliament simply to approve any spending that went above a minister’s original budget in midyear supplemental budgets.

States can avoid a fiefdom outcome at one stage of the process but not at others. In Belgium in the mid-1980s, for example, the prime minister often negotiated “fiscal contracts” with his ministers that led to budgets that, on paper, might have approximated the budget in equation 8, which was the solution the parties themselves favored. Yet, in practice, ministers could spend pretty much what they wanted during the implementation stage, which led to a serious common pool resource problem and budgets that approximated equation 7.

Delegation Governance

A significant body of literature concerns the question of how to solve collective action problems (Olson 1965; Ostrom 1990; Ostrom, Gardner, and Walker 1994). One possible solution is to appoint a central person to serve as an “entrepreneur,” whose function is to assure that all actors choose to cooperate. To be effective, the entrepreneur must have the ability to monitor the other players and must possess selective incentives that he can use to punish defectors and/or reward those who cooperate; and he must have some motivation to bear the costs of monitoring himself (Olson 1965). The spending ministers have reason to delegate power to such a fiscal entrepreneur. Although most players have an individual incentive to “defect” or overspend, they usually prefer the solution where all cooperate rather than where all defect.9

9. It is true that if a spending minister were to ignore the tax effects of spending, he would always want more spending and would not support delegation to a strong finance minister; but such ministers should be rare.
Among the cabinet members, the minister of finance (or minister of economy or treasury in some political systems) is most likely to play the role of a “fiscal” entrepreneur. He usually has the responsibility to coordinate the formation of the budget, and, fair or not, the overall conduct of fiscal policy, including the size of budget deficits, is the principal indicator that others use to judge his effectiveness. He may also have a trivial budget when compared with other ministers so that he cannot defect in the “prisoner’s dilemma game” being played in the cabinet. His interests, therefore, generally coincide with the general interests. Indeed, as former Swiss Finance Minister Otto Stich noted after his resignation in 1995, “every federal ministry has its lobby—I have only the taxpayers. They are the real majority, but their interests are unfortunately not well represented in parliament.”

A second reason why the minister of finance (or economy) is the most likely entrepreneur is that he may have the institutional capability to monitor the other ministries. The finance minister usually has an extensive staff trained in budgeting and accounting, and he is most likely to discover tricks spending ministers may use to justify additional spending. Because his prestige, and hence his personal benefits, depend on the effectiveness of his ministry, he has a private incentive to guarantee that the monitoring occurs. The only question is whether the finance minister has a privileged position in the budget process so that he can address the common pool resource problem.

Ex ante ministers submit budget bids that correspond to equation 2. Importantly, ministers would still like to receive budgets that correspond to equation 2, even if they do not receive this budget allocation in the budget law. This means that ex post ministers benefit from spending over their initial budget allocations. An effective finance minister must, therefore, hold a privileged position at both stages of the budget process to be effective.

There are a series of rules at the budget formation stage that strengthen the position of the finance minister. In the first stage, the minister of finance can serve as an agenda setter in the formulation of the budget by possessing the right to make the first proposal for the budget. This power is undermined if spending ministers can ignore the finance minister’s budget and get cabinet votes on their budget bids, allowing them to ignore the finance minister’s proposal. This procedure is the one commonly found in France.
minister of finance, together with the prime minister, issues a framework letter for every spending ministry that indicates the level of spending that ministry should expect to receive in the next budget year.

Another method *ex ante* is to have the minister of finance negotiate individually with the spending ministers, as is done in the United Kingdom. The chancellor of the exchequer is generally regarded as second in power only to the prime minister, and she usually negotiates with spending ministers individually about their budget allocations. Disputes between the finance minister and spending ministers go to a committee of senior ministers without portfolio for consideration and not to the full cabinet for resolution. These ministers do not have budgets of their own, and a log-rolling situation in favor of the spending minister is not possible. Because the senior ministers are appointed to consider the general interests of the cabinet as well, they usually support the chancellor. Further rules that strengthen the power of the finance minister include a right to veto any spending proposal, as in Germany. One can strengthen this rule with a requirement that the cabinet cannot overrule the decision of the finance minister, which is the case in Austria but not the case in Germany, where the chancellor plus a majority of the cabinet can overrule a finance minister’s veto. A final rule can require that the finance minister approve any changes to multiannual spending allocations.

An effective delegation to a fiscal entrepreneur also requires that the actors *ex post* do not defect from their initial budget allocations. The minister of finance, therefore, needs to have adequate monitoring power and a way to punish intransigent spending ministers. As long as he has the ability to modify a spending minister’s budget proposal, he can punish defectors in future years. If immediate action is required, he can appeal to the prime minister to take action, and, in the most extreme case, he can insist that the prime minister relieve the spending minister of his position. For her part, the prime minister generally enjoys a privileged position in any such battles. She can call a vote of confidence on an issue that puts the very existence of the government in question if a given minister does not support her position (Huber 1996). Other powers that the finance minister may have, in practice, include the power to block spending during the budget year, to approve all cash disbursements and to limit disbursements when the ministry thinks appropriate, and to approve all transfers across budget chapters.

This discussion also has implications for the parliamentary stage of the budget. Parliaments that can easily change the government’s budget proposal undermine the effectiveness of the finance minister. Disgruntled spending ministers can go around the backs of finance ministers and request that parliament pass their ideal budgets. An effective form of delegation, therefore, requires that parliament also delegate its power in the budget process to the finance minister. The expectation is that parliaments cannot significantly
change the government’s budget without the government’s approval, which, in practice, means the finance minister’s approval.

If delegation were equally effective across all forms of government, one could stop here and suggest that all countries strengthen their finance ministers appreciably and weaken the role of parliaments in the budget process. Yet the effectiveness of this form of governance depends on the party structure of the government. To see this, return to the model presented in the previous section and consider two parties in government, with party A controlling the finance ministry and some spending ministries and party B controlling some spending ministries. The ideal budget for party A remains the budget in equation 6, a budget that reflects the ideal spending preferences of party A only. The ideal budget for the coalition, however, is equation 8, which includes the ideal budgets of party B for those ministries that party B controls. What this suggests is that the greater the ideological distance between party A and party B the less likely it is that party B will be willing to delegate budgetary power to a finance minister; in game-theoretic parlance, the “principal-agent” problem becomes more severe. Coalition members simply will not trust a central player who must inevitably come from only one party to monitor and punish spending ministers in a manner that does not benefit the minister of finance’s own party. In coalitions where the parties will run against one another in future elections, there may also be a zero-sum game played between the parties. Any excessive spending by one party potentially helps that party in the next election and hurts its coalition partners. In contrast, in one-party governments, or in coalition governments in which ideological differences are minor, conflicts of interest among cabinet members arise primarily because of the common pool resource problem. The various ministers can be fairly sure that the finance minister holds more or less the same spending preferences as they do, and delegation of power to the finance minister is not problematic.

There is a second reason why delegation is most effective in governments with one-party governments. The punishment mechanism depends on the power of the prime minister, and by extension the finance minister, to reprimand or dismiss intransigent spending ministers. In one-party governments the dismissal of one minister from the same political party as the prime minister can be a heavy blow for the minister but have few consequences for the government. If the minister comes from a coalition partner, however, the

11. In its 1997 annual report, the Inter-American Development Bank suggested as much: “More hierarchical budget institutions that grant more power and responsibility to the finance minister (vis-à-vis other ministers) . . . can contain deficit bias and lead to permanent and meaningful improvements in fiscal discipline” (145).

12. Laver and Shepsle (1994, 9–10), for instance, in summarizing the findings of the case studies in their edited volume, note that the distribution of portfolios among members of the same political party has little effect on the policies that a government adopts; much more important is the distribution of portfolios among different parties.
partner may rally around the minister and force a showdown that can lead to a collapse of the government.

Delegation is, therefore, an option in one-party majority governments, such as the United Kingdom, where ideal budgets of the various ministries are close to one another and where all cabinet members will be on the same side in the next election. Delegation is also possible in countries where political parties are close to each other ideologically and where they usually run together as blocs in elections. In France, for example, the rightist RPR and UDF parties usually coordinate their electoral strategies. In Germany for the last twenty years the Free Democratic Party (FDP), Christian Democratic Union, and Christian Social Union (CSU) have in one bloc opposed the Social Democratic Party of Germany (SPD) and the Green Party. In such countries differences in ideal budgets among bloc partners are not large. Parties that expect to run together in the future do not have the worry that their partners will intentionally defect to increase their chances of winning the next election. Excessive spending hurts the coalition more generally.

Commitment Governance

The alternative to delegation that is available to coalition governments is committing to fiscal contracts. Parties that negotiate the budgets for every ministry consider the total tax burden on their coalition rather than merely the tax burden on their own parties, or, potentially even more damaging, individual ministries. They internalize the tax externality. Because the parties negotiate the budgets among themselves and set the contract, the benefit that individual ministers get simply from larger budgets for their ministries is also not included in the utility equation.

The natural place to negotiate such contracts is during the coalition negotiations. There are therefore two alternative ideal types of coalition agreements. The first type is the fiefdom model, where the parties simply negotiate the distribution of portfolios. The second type is commitment to fiscal contracts, and it involves detailed negotiations for every ministry. The prototypical example comes from the Netherlands. Future coalition partners negotiate detailed budgets for every ministry before the coalition negotiations are concluded. This suggests that the planning stage of the budget is important to commitment states. Coalition partners negotiate multiannual plans, and they expect annual budgets to remain consistent with these plans.

In practice, the plans amount to “fiscal contracts.” Questions that must be addressed by those making fiscal contracts include: What provisions exist to make sure that the parties stick by the contract? What happens if one or

13. This case, as well as the development of fiscal contracts in Belgium and in Finland, is discussed in detail in chapter 5.
more parties break the contract? and Under what conditions are contracts renegotiable?

First, negotiations among parties that result in commitment to a fiscal contract do not solve the common pool resource problem if the parties and/or ministers can easily violate the agreement ex post. Such violations could take place during either the decision-making phase, in which one or more parties might decide to break the agreement and demand more spending in one or more important areas, or during the implementation phase, in which one or more parties might choose to spend more than it was awarded in both the coalition agreement and in the annual budget.

In both situations, coalition members need to be able to detect possible defections. One issue concerns the contract design itself. Detailed provisions make it easier to determine whether an action violates the letter of the contract. Wide circulation of the provisions of the contract also makes it more likely that people outside government can identify defections. Within the government, the minister of finance can again play a role, but that role is necessarily more limited. Unlike the situation in delegation states, she will not have agenda-setting power and other strategic powers ex ante, because the common pool resource problem is addressed through the fiscal contract. Coalition parties have reason to suspect that the minister is biased toward her own party. While the finance minister can still assist in monitoring ministers ex post, the other parties will still want to monitor one another.

The obvious institution with enough staff and expertise to monitor cabinet members is the parliament. One would expect parliamentary committees to have the ability to monitor government ministries in commitment states. Committees may be designed so that they are responsible for keeping watch over one government ministry. The committee chair may be expected to come from a different party than the minister, which occurs in practice most of the time in countries such as the Netherlands. The committees may have other rights that reinforce their ability to collect information on the ministry under their jurisdiction, such as the right to call a minister before the committee for testimony and to subpoena ministerial documents.

What happens if a party defects? The punishment mechanism clearly differentiates commitment from delegation. A prime minister in a multiparty coalition cannot easily dismiss individual ministers who violate the contract if they come from a different party. Moreover, this solution is ineffective so long as the root cause of the problem is the party and not the individual minister. The likely punishment is therefore the dissolution of the coalition government itself; but this form of brinksmanship is a blunt, and often unsuccessful, tool. The effectiveness of such threats depends on the ability of coalition members to find alternative partners to replace any defectors. This requires some dynamism in party system structure. Coalition theorists tell us about the likelihood of a new coalition forming. Laver and Shepsle (1996)
argue that some parties cannot be excluded, because they have electoral
strength combined with a middle position in the country’s political spec-
trum. Other coalition partners cannot punish such strong parties in the
perspective presented here. Fiscal contracts in the presence of a strong party
are unlikely to work. Countries with a history of strong parties are likely to
have fiefdom governments.

The final question concerns renegotiation of the contract. One can imag-
ine situations in which one or more party is no longer satisfied with the orig-
inal contract. If a coalition partner expects to do much better after new elec-
tions, the contract and the coalition itself are probably at their end, and
renegotiation will not be possible. Early elections are the result and there
is no bargaining. A more interesting case is one where an unforeseen
event places a burden on the budget. How are the consequences of the bur-
den distributed among the coalition partners? Grilli et al. (1991) concen-
trate on the effects of economic downturns, and they argue that all coalition
governments (not just commitment governments) face gridlock during eco-
nomic downturns because they cannot negotiate the distribution of costs
(both budgetary as well as political) across coalition partners. The result is
policy drift and, during an economic downturn, large budget deficits.

The Grilli scenario probably describes well the situation facing fiefdom
governments, but it is not satisfactory for explaining the functioning of com-
mitment governments. First, parties can write detailed provisions into the
contracts to assure that there are very few “unforeseen” effects. Provisions in
the original contract for across-the-board spending cuts during negative
shocks or provisions that require that all additional revenue during a posi-
tive shock go to reducing the overall debt level (what today’s commitment
government in Belgium refers to as the Golden Hamster Rule) take the deci-
sion out of the hands of the coalition. Second, governments can make neg-
ative shocks less likely by writing contracts based on intentionally conserva-
tive estimates of future economic growth. If the expected annual real growth
rate of the economy over a four-year term is 3% per year, the government
may write fiscal contracts that estimate a growth rate of only 2.5%. As Haller-
berg et al. (2001) showed in their survey of fiscal rules in EU countries
during the period 1998–2000, commitment states regularly employ both tac-
tics to try to avoid contract renegotiations in the middle of a coalition’s term.
There is a clear role for the finance minister, but it is not the same as in del-
egation states. The finance minister is one guarantor of the fiscal contract,

14. In particular, Laver and Shepsle (1996, 69–71) differentiate between two types of
strong parties. A very strong party is one where no majority in parliament prefers an alter-
native coalition that excludes it. A merely strong party, in contrast, can threaten to veto cer-
tain alternative cabinets.

15. I will return to the point more formally later in the chapter when I consider a multi-
period game that allows borrowing from the future.
but she does not have the same powers as a delegation minister to introduce the budget or to change it during its execution.

Mixed Governance

Both delegation and commitment forms of governance assume that governments can pass their budgets through parliament relatively unchanged and with little difficulty. This assumption may be realistic in Western European countries with majority governments, but it does not describe the passage of legislation in countries with minority governments. By definition, minority governments do not have the votes in parliament to pass legislation without the help of the opposition. In that just under a third of all postwar European governments have taken a minority form, this point is not trivial (Tsebelis 1995). Moreover, minority governments have received less attention in the literature than majority governments and there is little consensus about how such governments affect the making of budgets. Some authors consider them to be highly unstable and incapable of passing significant legislation. Edin and Ohlsson (1991), in their reanalysis of Roubini and Sachs’s (1989) data set, found that minority governments are more likely than any type of majority government to run large budget deficits. In contrast, Strøm (1990) insists that such governments are relatively stable and that they are at least as effective as majority parties. Tsebelis (1995, 1999, 2002) even argues that there is no functional difference between one-party minority and one-party majority governments.

For the purposes of this book, which deals with budget policy, minority governments can take one of two forms of governance. Like majority governments they can lapse into fiefdom modes. To the extent that minority governments consider a smaller share of the overall tax burden than majority governments, one can anticipate that the common pool resource problem may be even worse in minority governments than in majority governments.

Yet there is a way that minority governments can avoid this fate, which in practice is a combination of the ideal types of delegation and commitment. The strong finance minister solution to the common pool problem is possible in minority situations at the cabinet level in one-party governments and in minority coalition governments where the coalition partners are close to one another ideologically. While a finance minister may coordinate the budget-making process within the government if there is one dominant party, as in delegation, this step is not enough. Centralization at the governmental stage can come to naught if the budget unravels in last-minute deals with the opposition that simply “buy” support from this or that party on key dimensions. As we shall see in chapter 7 Swedish Finance Minister Kjell-Olof Feldt learned this lesson in the late 1980s when it proved difficult for the minority Social Democratic government to pass its budget.
A more effective method is to include selected opposition parties in budget negotiations early in the process and, as in Denmark after 1982, reach agreement with them on all dimensions of the budget. This type of agreement, of course, resembles very much the agreements reached under commitment. The key difference is that the agreement is not negotiated with coalition partners. The government’s negotiations with the opposition are instead functionally equivalent to the coalition negotiations necessary under multi-party majority governments. The government agrees to fiscal contracts with certain opposition parties. In Sweden in 2001, for example, the minority Social Democrats negotiated a spending agreement with the Left Party as well as with the Green Party across twenty-seven different spending categories that, together, constituted the entire budget.

Consistent with the data presented in Strøm 1990, one would expect parliamentary committees to be especially strong in countries with frequent minority governments. As in the commitment case, these committees would monitor the government’s implementation of the budget to assure that it kept its part of the fiscal contract.

Factors in the Choice of Fiscal Governance

The underlying party system is the crucial factor for understanding why states adopt a given form of governance. The two features that matter are the level of competition in a political system and the ideological location of parties. If there is low competition, there is little incentive for parties to centralize the budget process. Individual cabinet members have an *ex post* incentive to spend more than either the finance minister (under delegation) or the fiscal contract (under commitment) would prescribe. If there is no punishment for overspending, there is no reason to constrain it. The ultimate punishment comes from the electorate. A given political party must fear an electoral sanction if it mismanages the budget, and, by extension, the economy.

The location of parties in ideological space relies on a long tradition in political science that maps the positions of parties. If the parties can be grouped together in two distinct blocs, then any coalition that forms will have parties that have few ideological differences. If the parties are not grouped together, then coalitions will have parties that have wider ideological differences.

Two factors, in turn, affect the likelihood that parties will bunch up in two distinct ideological camps. The first is the party system’s dimensionality. Lijphart (1999, 80–81) mapped the number, as well as the intensity, of different dimensions of the political system. A country such as Greece, for example, has a main left-right cleavage and a less dominant regime-support
cleavage. In comparison, Finland has several social cleavages with high salience, the left-right cleavage on economic issues and an ethnic cleavage (Swedish-speaking minority). Additional cleavages exist along religious, urban-rural, and regime-support dimensions.

The second factor concerns the electoral system. As Neto and Cox (1997) persuasively argue, there is an interaction effect between the number of relevant political cleavages in society and the electoral system. Following Duverger (1954), they argue that a plurality electoral system leads to a two-party political system, regardless of the number of underlying political cleavages. At the other end of the spectrum, a true proportional representation system leads to more political parties in rough proportion to the number of political cleavages plus one (Taagepera and Grofman 1985; Lijphart 1999). A political system with two dominant cleavages, for example, should have, on average, three main political parties. There are also proportional representation systems that have institutional rules to limit the number of parties in a political system. In Sweden, for example, a party must win 4% of the vote to qualify for entry into parliament. This type of system would fall between the two polar positions mentioned above.\textsuperscript{16}

This research is important for predicting the form the party system will take. If there is one cleavage, or if there is a plurality electoral system, there will be two main parties that face each other in elections. The governments that form under such a system will have cabinet ministers with few ideological differences. A political system with multiple relevant dimensions and a proportional representation system is likely to have several political parties that gain representation in parliament. No one party will be able to form a one-party majority government, and the coalitions that emerge will have parties with different ideological views. The case study chapters will consider this framework in more detail.

\textbf{Why Forms of Governance Matter}

Empirical evidence illustrates differences among the four models. The fifteen European Union states can be classified according to the different possible forms of fiscal governance for the time period 1973–2000 (table 2.1). One of the first things to notice is that the forms of fiscal governance do change. Eleven of the fifteen countries have changed their form of fiscal governance at least once during that period. The timing of changes is also relevant. Several states, including Austria, Denmark, Ireland, and the Netherlands,

16. Lijphart (1994) has created a threshold index, which represents the percentage of votes a party would need to win in order to gain parliamentary seats. The higher this index, the fewer parties receive representation.
had moved away from fiefdom before the Maastricht treaty was agreed to in December 1991. The EMU process did not cause the domestic changes in the budget process in these states. At the same time, there are a number of states that either introduced a new form of fiscal governance or strengthened a preexisting one in the mid-1990s. One question the case study chapters will ask is whether the changes in the budget process are due to EMU or to other reasons. Finally, the table reveals that delegation states tend to be more stable. Three large countries—France, Germany, and the United Kingdom—have had delegation forms of fiscal governments for the entire period studied here.

Does the delegation-commitment-fiefdom theory accurately predict which states will choose which type of fiscal institution? There are three hypotheses to test:

H1. Uncompetitive party systems are likely to have fiefdom governments.
H2. Countries with unstable party systems that generate several different types of government (one-party majority, multiparty coalition, and minority) will have fiefdom governments.
H3. Governments made up of coalitions with few ideological differences are appropriate for delegation, while those with many ideological differences are appropriate for commitment.

The countries have varying forms of fiscal governance. To capture the competitiveness dimension, the first column in table 2.2 shows the amount of time the party that was in government the longest remained in government. Note that the theory predicts that fiefdom will exist where there is at
least one party that is always in government. A party that has no fear of being replaced has little incentive to stick to any type of fiscal contract or to unite behind a strong finance minister. Moreover, if one party has no intention of sticking to budget agreements, there is little reason for others to do so. The second column displays a Herfindahl index that measures the concentration of a given type of government system. Finally, to predict what form of fiscal governance is adopted to centralize the budget process, which is a test of H3, one can consider the ideological distance among the parties in government. The prediction is that the greater the distance the more difficult it is for delegation to function in majority governments and the more likely it is that a commitment form of fiscal governance will be used. Moreover, under a mixed form of fiscal governance, one would expect the ideological distance to resemble the level of distance found in delegation states. The reason is that the finance minister centralizes the process within the government, but because of the government’s minority status it must make agreements with one or more opposition parties. The finance minister’s effectiveness would presumably decrease as the ideological distance increases.

The three hypotheses are largely confirmed (see table 2.2). Countries that have had fiefdom forms of fiscal governance have, with one exception, either had one party dominate the government (as in Italy) or had instability in the type of government (Portugal). The one exception is Spain. Delegation and commitment states, in contrast, have had both more competitive party systems and little or no rotation in the type of government. The clear exception in these two groups is Austria. In fact, the lack of competition undermined the functioning of commitment in the mid-1990s (chapter 8). An examination of the veto-player data largely confirms H3. A t-test indicates that the average for the commitment states is significantly different from both the delegation states and the mixed states.

17. An alternative measure would be a Herfindahl index to measure party concentration (Skilling 2001; Wibbels 2005). Yet it is difficult to conceptualize how to use this measure in coalition governments. How should one code the variable if only some of the parties leave the government while others remain? Skilling (2001) treats coalitions in Belgium and Italy the same, where some parties rotate in and out, yet he does not follow the same practice for Finland. Wibbels (2005) looks at only what amount to two-party systems in the United States and does not confront this problem. The theoretically relevant measure here is simply the greatest proportion of time that any one party remains in power.

18. This is measured as $1 - g_i$, where $g_i$ represents the proportion of time the country has a given type of government.

19. Veto-player data are based on Tsebelis’s Web page as well as the coding rules in Tsebelis 2002. The value is an average of three indices that measure party positions on a left-right dimension that is then averaged with Laver and Hunt’s (1992) score for the foreign policy position of the party. The indices used in the left-right average are from Castles and Mair 1984, Warwick 1994, and Laver and Hunt 1992. Note that the Portuguese president is not a relevant actor in fiscal policy decisions, so the figures used for this country differ somewhat from those reported in Tsebelis 2002.
Do differences in forms of fiscal governance have a tangible impact on policy outcomes? It would be most desirable to test the formal model directly, but “ideal” spending preferences cannot be measured in practice. What we can observe are strategies that individual parties and ministers pursue, but the strategies are not the same thing as preferences. A way around this difficulty is to consider a multiperiod game instead of a one-period game that allows government borrowing. As the formal models in Hallerberg and von Hagen 1999 and Velasco 1999, 2000 suggest, governments with serious common pool resource problems should run larger budget deficits, all else
being equal. According to this book’s framework, fiefdom governments should run larger budget deficits than the forms of government that address the common pool resource problem.

A regression analysis involving the current European Union states for the time period 1973–97, from the first oil shock through the year used to determine participants in EMU, shows the economic and political factors that influence government debt (table 2.3). The dependent variable is the change in the gross debt burden. This measure is used because it is more consistent over longer periods of time than changes in the budget balance. States did not necessarily use the same accounting standards to determine their budget balances, but there are few differences across countries in measuring gross debt. The analysis includes two groups of independent variables, explicitly political variables and economic variables that are included as controls.

To test the effects of forms of fiscal governance, there are dummy variables for each form that address the common pool resource problem. Fiefdom exists when the dummy variables all equal zero. One might anticipate that a change in government would lead to paralysis (or drift) in budget policy, so the fourth political variable codes changes in government. The fifth political variable measures the partisanship of the government in a two-dimensional policy space as coded in Tsebelis 2002. Increases in the partisanship variable represent a move rightward. The sixth political variable is the ideological distance among party veto players in government. Tsebelis (2002) argues that countries with larger ideological distances among veto players are likely to have fixed fiscal policies while parties with smaller ideological distances are likely to have more flexible fiscal policies. While Roubini and Sachs (1989) and Grilli et al. (1991) do not use the term “veto player,” their contention that coalition governments perform worse than one-party governments would imply that increases in the ideological distance among veto players should lead to increases in the gross debt burden over time. The data for veto players is the same as in Tsebelis 2002 with the exception of Portugal, which I recoded to take out the possible role of the Portuguese president. For both variables, I standardized them so that they range from 0 to 1. A dummy variable for whether a country has a fixed exchange rate tests whether fixed exchange rates imposed discipline on European Union countries. The data for the variable are from Clark and Hallerberg 2000. I also included a set of economic variables that one would expect would affect the gross debt burden, including changes in economic growth and unemployment. For robustness reasons, I included a lagged dependent variable to address auto-correlation and I calculated panel-corrected standard errors (Beck and Katz 1995; Beck 2001). Year dummies were

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20. Portugal’s president has little role in the budget process and is not a true “veto player.” I therefore adjusted the Tsebelis figures for years where the president’s party was not included in the government.
Table 2.3. Fiscal performance of European Union States, 1973–97

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Coefficient (Standard Error)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Political Variables</strong></td>
<td></td>
</tr>
<tr>
<td>Delegation</td>
<td>-1.33** (0.53)</td>
</tr>
<tr>
<td>Commitment</td>
<td>-1.63** (0.54)</td>
</tr>
<tr>
<td>Mixed</td>
<td>-1.89** (0.85)</td>
</tr>
<tr>
<td>Change in government</td>
<td>-0.25 (0.40)</td>
</tr>
<tr>
<td>Partisanship (Tsebelis two-dimensional coding)</td>
<td>0.08 (0.15)</td>
</tr>
<tr>
<td>Ideological distance, veto players (Tsebelis two-dimensional coding)</td>
<td>1.85 (0.31)</td>
</tr>
<tr>
<td>Fixed exchange rate</td>
<td>0.59 (0.48)</td>
</tr>
<tr>
<td><strong>Control Variables</strong></td>
<td></td>
</tr>
<tr>
<td>Intercept</td>
<td>1.68** (0.71)</td>
</tr>
<tr>
<td>Change in debt_{t-1}</td>
<td>0.42** (0.07)</td>
</tr>
<tr>
<td>Debt_{t-1}</td>
<td>0.47* (0.07)</td>
</tr>
<tr>
<td>Growth</td>
<td>-0.57** (0.11)</td>
</tr>
<tr>
<td>Change in unemployment rate</td>
<td>0.40* (0.23)</td>
</tr>
<tr>
<td><strong>N</strong></td>
<td></td>
</tr>
<tr>
<td><strong>R-Squared</strong></td>
<td>0.60</td>
</tr>
</tbody>
</table>

Note: Dependent variable: change in the gross debt burden.

included (but not reported) to control for year-specific fiscal shocks, and the regressions results were computed using Stata 8.1.

The results show that the forms of fiscal governance have real effects on budget outcomes. The intercept term indicates that debt levels are expected to grow at around 1.7% of GDP per year in fiefdom countries. All the forms of fiscal governance variables are statistically significant in the expected direction. Introducing any of the forms of governance to address the common pool resource problem reduces the growth of the debt level in the fiefdom case. This means that swings in the economy in the form of output growth or changes in unemployment largely dictate increases or decreases in the debt burden.21

The remaining political variables have little impact on budget discipline. An increase in the veto player ideological distance has the correct sign but is not statistically significant. Partisanship seems to have no impact on the debt burden, while fixed exchange rates do not serve as a way to impose fiscal discipline.

21. The question is: Does a country expand the debt burden in years when it is experiencing average growth? One can test for the linear combination of a given form of fiscal governance with the intercept term and with the average level of growth times the coefficient of growth to determine expected changes in the debt burden given an average growth year. If year dummies are included, one is technically testing for the effects of fiefdom in the excluded year (1980 in the reported results), so it is necessary to exclude the year dummies. With standard errors reported in parentheses, the expected growth of the debt burden in an average growth year under fiefdom is statistically significant at 1.68 (0.60), while there is no expected growth in the debt burden under average growth under any of the three forms of fiscal governance meant to address the common pool resource problem (coefficients of 0.28 (0.47) for delegation, 0.13 (0.70) for commitment, and -0.13 (1.00) for mixed).
The case study chapters that follow are organized by type of party system, the crucial variable in determining the form of fiscal governance a country will adopt. Four countries have systems either where one party consistently wins a majority of seats (Greece, United Kingdom) or where groups of parties with minor ideological differences run in elections as blocs (France, Germany). From them one would expect delegation forms of fiscal governance. Four countries (Belgium, Finland, Luxembourg, and the Netherlands) have regular majority coalition governments where partners routinely run against each other, and commitment would be expected to develop in these countries. Denmark and Sweden have minority governments, and they should be expected to have mixed forms. Austria, Ireland, Portugal, and Spain do not have stable party systems that yield one form of government (one-party/coalition, minority/majority). Their forms of fiscal governance, while often taking root, are not as well institutionalized as in countries with more stable party systems. Finally, Italy is a wonderful test case. It changed its electoral system in 1994, which has had notable effects on the country’s party system. The predicted type of fiscal governance that would be appropriate for Italy shifted from commitment to delegation.

The competitiveness of the party system is crucial—states remain stuck with fiefdom governments when they have uncompetitive elections. Moreover, the EMU framework can be interpreted as a set of rules as well as a set of requirements to monitor budgetary performance. Economic and Monetary Union is consistent with a rules-based form of fiscal governance, and it has enhanced the fiscal performance of commitment states such as Belgium, Finland, and the Netherlands. It is not, however, consistent with a discretion-based form of fiscal governance. It is no surprise that delegation states such as France, Germany, and (today) Italy are having difficulties abiding by the provisions of the Stability and Growth Pact in 2002–2004, years that are beyond the focus of this study.

22. Because of data limitations for Luxembourg, however, I do not consider Luxembourg in this chapter.