An enlarged EMU? The procedural sources of fiscal policy in the new Member States

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Abstract: Ten new countries joined the EU in 2004, and some of them will soon also join the euro. Since their incorporation to the single currency is subject to their fulfilment of the Maastricht criteria that current members already fulfilled in 1998, this paper describes and compares these fiscal adjustments. Because fiscal consolidations vary in their timing, their duration and their composition, the article explores these dimensions and presents a model that enables us to explain such variation. Some empirical evidence pointing to the relationship between budgetary procedures and the level of fiscal discipline is shown.

Keywords: EU enlargement; fiscal discipline; fiscal institutions.

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1 Introduction

A decade and a half after the collapse of the Soviet Union and the fall of the Berlin Wall, ten Central and Eastern European Countries (CEECs) have finally joined the European Union.

Before reaching this point, these countries have surmounted the obstacles posed by the need to implement difficult and intensive economic and institutional reforms, in order to comply with the three criteria imposed by the EU for their membership: to complete the transition to the market economy, to develop stable democratic institutions that safeguard human rights, and to incorporate fully all of the Community's legislation (the *acquis communitaire*).

As 12 of the 15 current EU Member States already use the single currency and are subject to the provisions of the Stability and Growth Pact signed in 1997, which states that the public deficit of each Member State shall not breach the limit of 3%, and should tend towards equilibrium, most candidate countries have already introduced significant fiscal reforms during the last decade, so that they may join the Euro zone as soon as they fulfil the nominal convergence criteria.

Most countries have recently made significant advances in terms of macroeconomic stabilisation, but have made only slight progress in terms of fiscal consolidation. Average public deficit in candidate countries, for example, actually increased from 3% of GDP in 2000, to 3.5% in 2001 and 3.9% in 2002.

According to the European Commission (2000, 2001) Bulgaria is the country which has implemented the most significant degree of fiscal adjustment. Slovenia and Poland have maintained a reasonable degree of budget stability, while Hungary has opted for a more gradual strategy of fiscal consolidation. At the same time, the smallest countries (Cyprus and Malta) remain in a situation of unsustainable fiscal disequilibria, while the Baltic countries are still trying to recover from the hard fiscal shock to their budget balances at the end of the last decade caused by the crisis in Russia.

In terms of budget composition, during their candidacy, most of the new Member States made huge efforts to increase their public revenues: massively privatising public enterprises, enlarging the tax base, introducing value added taxes, improving the tax collection systems and/or fighting tax evasion.

On the expenditure side, it was not easy to make improvements: difficulties in introducing some reforms that were crucial for the sustainability of their budget balances in the medium term could cause additional problems once they joined the Euro zone. For example, in Hungary and the Czech Republic new cases of fiscal opacity reappeared; in Poland, a municipal reform lacked specific plans for the distribution of competences between the different levels of government, and spending associated with the provision of public services doubled. In other cases, such as Latvia, the Slovak Republic or Slovenia, social security reforms have been minimal (European Commission, 2001).

That is, not only do we find that some candidate countries had already consolidated their budgets while others had not, but also, it is possible to observe important differences in the adjustment strategies designed and implemented by different countries.

While some of them decided to launch shorter and more drastic adjustments (Bulgaria), others decided to make changes more progressively and long-lasting, and some decided not to adjust. Moreover, some of the countries, such as the Czech Republic or the Slovak Republic, wishing to correct their fiscal imbalances decided to follow a revenue-based strategy, while others preferred to rely on spending cuts (Hungary, Lithuania or Poland).

This variation in the fiscal stance of the new Member States is precisely the issue this study plans to examine. More specifically, the aim of this paper is to ascertain if different budgetary institutions may have had any effect on this observed change in the CEECs' public finances.

Traditionally, fiscal policy is determined by a set of economic and politico-institutional factors. Among them, the most important economic factors are the economic cycle, monetary policy and the accumulated level of debt, while the most important political ones are the ideology of the party in government, the proximity of elections and the degree of fragmentation in decision making (Mulas-Granados, 2003a). This latter aspect is mainly a function of the electoral and party system and the underlying budgetary procedures. Since the topic of the economic determinants of fiscal policy in the CEECs is being extensively studied by the European Commission, we prefer to take some additional steps into the relatively less explored field of the relationship between budgetary institutions and public finances in the new EU Member States.

The paper is structured as follows: Section 2 presents the most recent fiscal developments in the new Member States and comments on the situation of each country's public finances. Section 3 discusses the theoretical forecasts of the literature on budgetary institutions, and puts forward some hypotheses about the possible influence of budgetary procedures on the fiscal behaviour of each country. Finally, Section 4 presents indirect evidence pointing to the relationship between centralised budgetary procedures and higher levels of fiscal discipline. Section 5 summarises and concludes.

2 A first look at the data: fiscal developments in the New Member States

The first thing that must be pointed out when dealing with fiscal data in the new Member States is that there are some serious doubts about their stability and reliability. The time-series for the last decade include structural breaks as definitional adjustments have not often been applied retroactively. This means that fiscal data for the early years of the period provide, at best, only an approximate indicator of the underlying budgetary situation (European Commission 2002, 2003).

The second aspect that must be taken into account when studying the public finances of these countries is that they have all gone through a period of transition to a market economy. According to the most relevant studies in the field, budget deficits typically appear at the beginning of transition periods, and especially in fast reforming countries (Pirttilä, 2000). As transition advances, one can expect fiscal positions gradually to improve following reforms in tax systems and enhanced efficiency in the economy in general (other things being equal). This is subject to the kind of reform strategy adopted.

Slow reformers cut subsidies more aggressively but had to increase social expenditure to compensate for those individuals affected by market reforms. As the European Commission (2002) also noted, a high fiscal deficit may, in fact, be an inevitable by-product of a successful transition, rather than, necessarily, an indicator of inadequate fiscal policy.

Tables 1 and 2 present simple descriptive statistics related to the general government balance (%GDP) and the annual change in public expenditure (%GDP).

Table 1 Public finances in the CEECs, 1994–2002: descriptive statistics

Year	*Mean budget balance*	*Standard deviation*	*Range (min/max)*
1994	−2.7	2.7	From −8.4 (HUN) to 1.3 (EST)
1995	−2.9	2.3	From −6.7 (HUN) to 0.4 (SKA)
1996	−3.4	2.9	From −10.3 (BUL) to −0.2 (SNA)
1997	−2.3	2.3	From −5.2 (SKA) to 2.2 (EST)
1998	−2.7	2.4	From −5.8 (LIT) to 1.3 (BUL)
1999	−3.9	2.2	From −6.4 (SKA) to 0.4 (BUL)
2000	−3.3	2.8	From −10.4 (SKA) to −0.4 (EST)
2001	−3.0	2.4	From −7.3 (SKA) to 0.2 (EST)
2002	−3.3	3.1	From −9.2 (HUN) to 1.3 (EST)
Year	*Mean Δ public expenditure*	*Standard deviation*	*Range (min/max)*
1995	−1.0	2.5	From −6.1 (HUN) to 1.2 (CZE)
1996	−1.1	1.6	From −3.8 (HUN) to 1.8 (SKA)
1997	−1.2	3.1	From −9.3 (BUL) to 1.5 (LAT)
1998	1.2	2.5	From −2.6 (SKA) to 5.7 (BUL)
1999	0.5	2.5	From −5.6 (HUN) to 3.3 (LIT)
2000	−0.8	3.1	From −7.3 (LIT) to 2.3 (HUN)
2001	1.0	4.8	From −4.4 (LAT) to 13.4 (HUN)
2002	0.9	2.6	From −2.4 (LIT) to 6.8 (HUN)

Source: Yalloutinen (2004) and own elaboration. Data from EBRD (2001, 2002) and European Commission (2003). All figures refer to general government.

Table 2 Public finances in the CEECs, 1994–2002: country specific figures

Budget balance	*BUL*	*CZE*	*EST*	*HUN*	*LAT*	*LIT*	*POL*	*ROM*	*SKA*	*SNA*
1994	−3.9	−1.1	1.3	*−8.4*	−4.4	−4.8	−2.2	−2.2	*−1.5*	−0.2
1995	−5.7	−1.1	−1.3	*−6.7*	*−4.0*	−4.4	−3.1	−2.5	*0.4*	−0.3
1996	*−10.3*	−1.7	*−1.5*	*−5.0*	*−1.8*	*−4.5*	*−3.3*	−3.9	−1.3	−0.2
1997	*−2*	−2.1	*2.2*	*−4.8*	*0.3*	*−1.8*	*−3.1*	−4.6	−5.2	−1.7
1998	*1.3*	−2.4	−0.3	−4.8	−0.8	*−5.8*	*−3.2*	*−5.0*	−5.0	−1.4
1999	*0.4*	−3.7	*−4.0*	*−5.6*	*−5.3*	*−5.7*	*−1.5*	*−4.5*	−6.4	−2.2
2000	−0.5	−4.0	*−0.4*	*−3.0*	*−2.7*	*−2.6*	−1.8	*−4.6*	*−10.4*	*−3.3*
2001	0.2	*−5.5*	*0.2*	−4.7	*−1.6*	*−2.2*	−3.0	*−3.3*	*−7.3*	*−2.8*
2002	−0.6	*−3.9*	*1.3*	−9.2	−3.0	*−2.0*	−4.1	*−2.2*	*−7.2*	*−2.6*
Δ Public expenditure	*BUL*	*CZE*	*EST*	*HUN*	*LAT*	*LIT*	*POL*	*ROM*	*SKA*	*SNA*
1995	−4.4	1.2	0.7	−6.1	1.0	−1.6	−1.3	0.8	−0.3	−0.2
1996	0.7	−0.8	−1.0	−3.8	−2.0	−1.6	−2.8	−0.9	1.8	−0.5
1997	−9.3	−0.5	−2.9	0.7	1.5	−0.7	−0.6	0.2	−1.5	0.9
1998	5.7	−0.8	2.0	0.9	2.3	4.1	−1.2	0.7	−2.6	0.6
1999	2.2	1.0	3.1	−5.6	0.8	3.3	−0.7	0.5	0.4	0.1
2000	1.4	1.8	−4.1	2.3	−2.1	−7.3	−1.3	−0.2	2.1	−0.4
2001	−1.4	1.0	−0.8	13.4	−4.4	−1.9	2.6	−0.6	2.3	0.2
2002	−0.7	3.1	1.5	6.8	−0.1	−2.4	0.5	−0.8	2.3	−0.8

Note: In bold and italic are episodes of fiscal consolidation.
Source: Yalloutinen (2004) and own elaboration. Data from EBRD (2001, 2002) and European Commission (2003). All figures refer to general government.

While the average budget balance has remained stable in the interval 2.5–4.0%, it immediately becomes clear that large differences exist across the CEECs when we look at the dispersion of this average. Some countries such as Hungary, Bulgaria or the Slovak Republic recorded budget deficits above 10% of GDP, while others such as Estonia performed budget surpluses of 2.2%. We can also observe a trend towards a decrease in total spending as a percentage of GDP from 1994 to 1998, which reverses in the following period up to 2002. Finally, Table 2 shows that over the period, there were important episodes of fiscal adjustment (defined as periods where the budget balance improved by at least 0.5% of GDP).

As most prominent studies in the field show (Alesina and Ardagna, 1998; Alesina and Perotti, 1995; Giavazzi and Pagano, 1990; Mulas-Granados, 2003b; Von Hagen et al., 2001) any government confronted with the need to reduce its budget deficit has to design a strategy of fiscal adjustment with four dimensions: the cabinet has to decide:

- the size of the adjustment it wishes to undertake
- when the adjustment (timing) is going to be launched
- how long the adjustment episode is going to last (duration)
- what are the items of the budget that will be affected by this adjustment effort (composition).

The size and duration of fiscal consolidations is important because if they are too short and very intensive, they can start a recession in situations where the private sector does not offset the decrease in public demand originated by fiscal contraction fast enough; while, if they are slow and sustained, they can have very negative political consequences for the government implementing these measures. In addition, the duration of fiscal consolidations is strongly related to their composition, because those adjustments that rely mostly on cuts in the government wage bill and in public transfers are likely to last longer (and thus to be successful), than those which rely on increased revenues and reduced public investment (Alesina and Ardagna, 1998).

Any government willing to decrease its public deficit has five options:

- to increase revenues more than expenditure
- to increase revenues and freeze expenditure
- to increase revenues and reduce expenditure
- to freeze revenues and reduce expenditure
- to reduce revenues less than expenditure.

Basically, consolidations that rely on the first two strategies of adjustment can be called revenue-based adjustments, and those based in the last two strategies, can be called expenditure-based adjustments. The third possibility is somewhat in between, and this is why it can be called a mixed strategy. For example, the European Commission considered that Austria, Belgium, Denmark, the Netherlands, and Spain, all implemented mixed strategies to qualify for EMU in the mid-1990s, because they first relied on revenue-based approaches, and finally turned to expenditure-based approaches, when it became clear that the initial strategy would not be enough to meet the criteria (European Commission, 2000).

As Table 3 shows, there have been 15 episodes of fiscal adjustments between 1994 and 2002 in the CEECs distributed over 50 years. Estonia, Hungary, Latvia, Lithuania and the Slovak Republic had two episodes while the rest had only one. Episodes of adjustment have differed in their timing, duration, size and composition across countries. While some episodes lasted only two years, others lasted six years. The average size of those adjustments was 3.4 points of reduction in the deficit as a percentage of GDP, but with an important dispersion between cases of very large deficit cuts (10.4%) and other more minor consolidations (0.9%). Finally, the bulk of adjustment episodes (66.6% of them) were expenditure-based, while only five out of 15 were revenue-based. This contrasts with the experience of (EU-15) current Member States most of which consolidated their budget in the run-up to EMU raising revenues and not cutting spending (Mulas-Granados, 2003). In fact, this may be an important reason why most recent fiscal adjustments in new Member States have been successful (Purfield, 2003).

Table 3 Characteristics of fiscal adjustments in CEECs, 1994–2002

Country	*Timing*	*Duration*	*Size*	*Composition*
BUL	1996–1999	4	10.7	Exp-based
CZE	2001–2002	2	1.6	Rev-based
EST	1996–1997	2	3.7	Rev-based
	1999–2002	4	3.7	Exp-based
HUN	1994–1997	4	3.6	Exp-based
	1999–2000	2	2.6	Exp-based
LAT	1995–1997	3	3.7	Rev-based
	1999–2001	3	3.7	Exp-based
LIT	1996–1997	2	2.7	Exp-based
	1998–2003	6	3.8	Exp-based
POL	1996–1999	4	1.8	Exp-based
ROM	1998–2002	5	3.2	Exp-based
SKA	1994–1995	2	1.9	Rev-based
	2000–2002	3	3.2	Rev-based
SNA	2000–2002	3	0.9	Exp-based
TOTAL	15 episodes	50 years	3.4 average	5 Rev-b/10 Exp-b

Source: Own elaboration

With this evidence in hand, an important question to be answered concerns the economic and political factors which may explain why countries chose a different strategy of adjustment.1 Although important, this issue is nonetheless preceded by a more crucial one: since the strategic choices related to the timing, size, duration and composition of fiscal adjustments are intrinsically determined by the underlying budgetary institutions of each country, can we identify any relationship between budgetary institutions and fiscal discipline in the CEECs? What type of relationship is this, is it a positive or a negative relationship?

In order to answer these questions, let us examine the views expressed in the literature on this aspect.

3 The theory of budgetary institutions and fiscal policy

In the literature on budgetary institutions, three different phases of a budget process are usually identified: the formulation of a budget proposal within the executive, the presentation and approval of the budget in the legislature, and the implementation of the budget by the bureaucracy.

Most of the literature has focused on the first two phases of the budget process. This emphasis seems justifiable since these phases establish who influences the final budget outcome and when, as well as the size of the budget. These phases also illustrate the different decision making arenas in a budget process: the executive formulates the budget

proposal after which the legislature debates and amends it and votes on it. In this paper we only review the literature on decision-making within the cabinet. However, the relationship between the executive and the legislature is not without significance from the fiscal standpoint either. The legislature's power vis-à-vis the executive is defined by the type of voting and amendment rules in the plenary and more generally by the overall characteristics of its parliamentary committees (Table 4).

Table 4 The budget process

Action
Executive Planning Stage
Formulation of budget target and guidelines
Preparation of budget bids
Compilation of budget draft
Reconciliation
Finalisation of budget proposal
Legislative Approval Stage
Debate, amendment of and vote on budget proposal
Approval by government
Implementation Stage
Execution of the budget act
In-year changes of the budget
Ex-post Control and Accountability

Source: Von Hagen and Harden (1994)

One major implication of the common-pool models is that where fiscal institutions make participants in the budget process internalise the costs of budget deficits, this will lead to smaller budget deficits (Weingast et al., 1981). In this respect, it seems obvious that the centralisation of decision making in the budgetary process can help overcome fragmentation by allowing a comprehensive view of the budgetary implications of all measures and forcing participants to recognise the real costs and benefits of each measure.

Indeed, the existence of fiscal biases stemming from economic policy aspects justified two ways of promoting centralisation in different phases of the budget process, and consequently fiscal rigour: *commitment* which is achieved via a set of binding limits on expenditure which are collectively negotiated at the budgetary process, and *delegation* of fiscal powers to a fiscal 'entrepreneur' (prime minister or 'strong' finance minister) (Alesina and Ardagna, 1998; Alesina and Perotti, 1995; Giavazzi and Pagano, 1990; Mulas-Granados, 2003b; Von Hagen et al., 2001).

Delegation essentially implies a transfer of fiscal powers from the legislature to the executive, and within the executive from the various spending ministers to the finance minister. To be effective, the entrepreneur in the delegation approach must be able to monitor others, have selective incentives at his disposal, and be willing to bear the costs of monitoring. Once the government has approved the budget, the parliament can make

only limited amendments to it. Under the commitment approach, the targets are negotiated among the different ministers at the beginning of the budgetary process, often on a multi-year horizon. Agreed targets become binding for all departments and are regularly reviewed to verify compliance. The finance minister's role can be important especially in enforcing the existing contract. The parliament is in a strong position with respect to this process, especially in monitoring the implementation of the budget.

The type of budgetary process chosen by each country has typically been highly correlated to the electoral system and the cleavage structure it has (Von Hagen and Harden, 1994). Therefore one could expect that the following conditions will apply (Hallerberg et al., 2001):

Commitment approach: countries with multi-party majority governments (most likely to be found in countries that have proportional elements in their electoral systems and/or diffused cleavage structures, not likely to be found in countries with undisciplined voting behaviour). *Delegation approach*: countries with single-party majority governments (most likely to be found in countries that have majoritarian elements in their electoral systems and/or simple cleavage structure), or multi-party majority governments with scant ideological differences.

In fact, the majority of the CEECs have proportional electoral systems which, together with their multi-dimensional cleavage-space, suggest the dominance of the commitment approach. The majority of the CEECs should thus belong to this category. Hungary would seem to be an exception. While it does not have a pure two-party system, a certain degree of bipolarity has been a consistent feature of Hungarian politics throughout the 1990s. This suggests that, unlike the other CEECs, fiscal institutions in Hungary can be expected to include features from the delegation approach. Many countries such as Bulgaria, the Czech Republic and Romania have experienced frequent shifts in their government types, which implies that they could also shift from the commitment to delegation approach or have components of both.

Poland would be a candidate for a commitment approach as coalition governments have been dominant, but it has experienced rather volatile political conditions. The behaviour during budget voting has also often been undisciplined. This indicates a hybrid approach for Poland. Lithuania has had a fairly high degree of stability, but interestingly, the type of government has concentrated on a single-party government during the first part of the period, while it has had a consistent stream of coalition governments in the latter part. Lithuania's ideal form of fiscal management could have thus changed during the 1990s. Slovenia should be a candidate for the commitment approach but undisciplined voting behaviour, combined with signs of a low degree of party competition, makes us think that it has developed features of a more hybrid approach. In the remaining countries, the commitment approach should be dominant.

These theoretical predictions are in most cases matched by empirical facts. The reality in the planning and decision-making stage broadly speaking corresponds with the theoretical arguments presented above. As expected, the commitment element in the planning and decision-making stages is strong in the majority of the CEECs. The cabinet possesses a strong role in setting the targets, negotiating the budgets and resolving the emerging conflicts. The commitment element of the fiscal frameworks has also been strengthened (albeit to a varying degree) by the introduction of multi-annual budgeting. Some of the important elements of the commitment approach are, however, lacking as these processes are still taking shape.

Based on the information about the executive stage reported by Yalloutinen's questionnaire (2004), one may think that fiscal targets are in general 'weak'. In other words, the targets are based on a political commitment and they serve as a non-binding or indicative benchmark for the budget-making process. The majority of countries do not discuss the deviations between objectives laid out in the multi-annual plans and actual outcome. This weakens the credibility of multi-annual targets or guidelines. Typically, the CEECs do not have clear provisions in place on what should be done in times of economic under or over- performance. Furthermore, in all these countries the multi-annual targets are agreed within the cabinet but as a rule such countries do not include the agreed commitment in the coalition agreements. Therefore, the defection from jointly negotiated targets is easier as monitoring of compliance becomes more difficult and political costs from defection are smaller. Nevertheless, it is worth noting that many countries are still in the process of developing their multi-annual frameworks.

According to Yalloutinen (2004), the two countries with the most powerful finance ministers in the decision and planning stages are Hungary and Slovenia. With regard to Hungary, this was expected from the previous theoretical discussion. Slovenia, on the other hand, has consistently had coalition governments, but the prediction was that the undisciplined voting behaviour and a certain degree of dominance by one party might not have encouraged the development of the commitment approach. In both countries the bilateral budget negotiations have had a more prominent role, the finance minister has, in practice, a right to veto significant changes in the budget proposal and the prime minister (not the full cabinet) ultimately resolves any disputes. Bulgaria, Poland and Lithuania do not have jointly negotiated annual fiscal targets nor do they have strong finance ministers. To some extent this applies also to Romania. In recent years all of these countries have, however, strengthened their budget processes towards the commitment approach by employing both annual and multi-annual fiscal targets negotiated in the cabinet.[2]

In the legislative stage of the budget process, the countries have sought to employ different schemes in order to limit the parliamentary amendments. As a result, the legislature's opportunities of altering the executive's budget proposal are, in general, limited. Contrary to theory, delegation states do not have weaker parliaments in the legislative stage compared to commitment states.

The evidence from previous paragraphs shows that the variation in the institutional set-up across the CEECs is considerable. Nonetheless, this variation is smaller than the one observed across the EU-15 Member States (see Table 5). At the same time, and in spite of this higher variation, some aspects commonalities can be identified: for example, the EU-15 Member States have developed somewhat stronger finance ministers and stronger parliaments than the CEECs (Yalloutinen, 2004).

Table 5 The budget process and the institutional choice

Member States	*Institutional choice*	
	Contract	*Delegation*
EU-15	Austria, Belgium, Denmark, Netherlands, Portugal, Finland, Ireland, Luxembourg, Italy, Spain, Sweden	Germany, France, UK, Greece
CEECs	Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Romania, Slovak Republic, Poland	Hungary, Slovenia

Source: Own elaboration based on Von Hagen et al. (2001) and Yalloutinen (2004)

In summary, this section has clearly established that there are some differences between the fiscal frameworks of the CEECs. The interesting question then is how these differences may have affected the fiscal performance of these countries.

4 Institutions and fiscal policy: empirical results

One method often used to test whether the differences in the fiscal frameworks have had any impact on the fiscal performance is to construct indexes which describe the institutional characteristics of the budget procedures in a given set of countries. Typically, the indexes measure the finance minister's strength over spending ministers in the planning, decision making and implementation stages, and the executive's strength over the legislature in the legislative stage of the budget process. These indexes are then used as explanatory variables of the different measures of fiscal performance. This is the approach taken in Yalloutinen (2004) too.[3]

However, while the indexes describe the overall characteristics of budget procedures, they do not make any distinction between the different forms of fiscal institutions discussed in earlier chapters (i.e. commitment and delegation). The theoretical considerations suggested that countries with decentralised fiscal institutions are more likely to suffer from a lack of fiscal discipline compared to countries with commitment and delegation approaches.[4] For the earlier period, the mean budget balance-to-GDP ratio of these countries (−3.8%) is indeed larger than that of the other countries (−2.2%). Particularly striking is the difference with respect to the commitment countries (−1.6%).

The theory suggested further that commitment states rely more on jointly negotiated fiscal targets than on a strong finance minister. Therefore, it can be questioned whether an index which emphasises the dominance of the finance minister's role should be used in the case of the commitment states.[5] The majority of the CEECs do have a strong commitment element in their fiscal institutions in the sense that the cabinet makes most of the fiscal decisions, not the finance minister. However, based on the evidence presented in Chapter 4, there are some reasons to believe that in the past the commitment element has not been sufficiently strong in these countries to guarantee fiscal discipline.

In the commitment countries of the EU-15 there might indeed be less need for a strong finance minister as the agreed multi-annual plans are cemented in the coalition agreements which contribute to ensuring fiscal discipline. For example, Hallerberg et al. (2001) find that, when formulating the multi-annual plans, strong finance ministers have been effective only in non-commitment (delegation and hybrid) countries. This result was driven by the fact that commitment countries write their budget plans against the background of coalition agreements and the finance minister's influence is thus smaller. In the CEECs, the finance ministers' influence is likely to be more significant in this sense as the use of coalition agreements, as a tool for enhancing fiscal discipline, is not widespread. The commitment element has been strengthened by the introduction of the multi-annual frameworks, but this has not happened until very recently. Thus the practices are still taking shape, and their impact cannot yet be analysed.

Therefore, it can be argued that a strong finance minister has been necessary to complement the jointly negotiated targets. Consequently, countries that have decided to invest their finance ministers with more fiscal powers should have enjoyed more effective

fiscal discipline. This hypothesis can be tested by means of the indexes that describe the relationship between the finance minister and the spending ministers.[6]

The following indexes built by Yalloutinen (2004) cover different phases of the budget process measuring the strength of the institution in question: the finance minister in the planning and decision-making stage *(MFD)*, the parliament in the legislative stage *(PL)* and the finance minister in the implementation stage *(MFI)*. Regression results presented in that study also include an index which measures the connection between the pre-accession economic programmes and annual budgets (PEP). All indexes used are calibrated so that the potential range of the indexes runs from 0 to 8. An increase in an index-value means that the strength of a particular institution is strengthened, unless noted otherwise.

The ordinary least squared regressions from a panel data set have the following basic form:

$$X_{it} = \beta_0+\beta_1 MFD_{it}+\beta_2 PL_{it}+\beta_3 MFI_{it}+\beta_4 PEP_{it}+\beta_5 GDP_{it}+\beta_6 UNE_{it}+E_{it}$$

where X denotes the dependent variable (the budget balance-to-GDP ratio or annual change in the public expenditure-to-GDP ratio, depending on a regression) in country i, β_0 is a common intercept for all pool members, GDP is an annual real growth rate and UNE an unemployment rate in a given country, and they are added together to capture the effects of economic fluctuations. *MDF, PL, MFI* and *PEP* refer to different indexes as explained above. Finally, E refers to an error term. In the regression presented by Yalloutinen (2004) (see below), the indexes are entered in the regressions first together to test the combined effect and then separately to test their effect independently of each other. Control variables (*GDP* and *UNE*) are included in all regressions.

When budget balance is used as a dependent variable the expectation is that $\beta_1,\beta_3>0$ (a less decentralised budget procedure should be conducive to stronger budget balance), $\beta_2<0$ (the theory expects that parliaments which have the power to alter significantly the executive's budget proposal weaken fiscal discipline), $\beta_4>0$ (better connection of the PEP with the annual budget process should enhance fiscal performance), $\beta_5>0$ (economic growth should strengthen the budget balance) and $\beta_6<0$ (higher unemployment should be conducive to a weaker budget balance). When the annual change in public expenditure is a dependent variable, the expected signs are exactly opposite to those just presented. In other words, a negative value of a correlation coefficient is associated with a decrease in public expenditure. This should be the case when the degree of centralisation of the budget process is increased.

Due to a structural break in the fiscal data of these countries, all studies in the field divide the sample in two parts (before 1998 and after 1998). Table 6 presents the ordinary least squares for the first period, 1994–1998. The results indicate that indexes cannot explain differences in the fiscal performance in the CEECs.[7] When a Δ public expenditure is used as a dependent variable, correlation coefficients are not significant and coefficients even have wrong signs. When budget balance is used as a dependent variable, the index coefficients have correct signs but the significance of the results is very poor. Also R-squared is small in all regressions.

Table 6 Institutions and fiscal policy in the CEECs (OLS): 1994–1998

	Dependent variable	
	Budget balance	*Δ Public expenditure*
Constant	−1.18 (0.93)	0.79 (1.02)
Finance Minister Index (Decision)	−0.30 (0.21)	−0.22 (0.21)
Parliament Index (Legislative)	0.16 (0.33)	0.36 (0.33)
Finance Minister Index (Implementation)	0.04 (0.13)	−0.21 (0.16)
Economic growth	0.28*** (0.09)	0.09 (0.11)
Unemployment	−0.19** (0.08)	−0.12 (0.09)
R^2	0.28	0.09
N	50	50

	Dependent variable					
	Budget balance			*Δ Public expenditure*		
	(1)	*(2)*	*(3)*	*(1)*	*(2)*	*(3)*
Constant	−0.52	−2.71	−2.25***	0.79	−0.26	0.56
	(0.97)	(1.11)	(0.74)	(0.94)	(0.99)	(0.86)
Finance Minister	−0.35			−0.10		
Index (Decision)	(0.23)			(0.24)		
Parliament Index (Legislative)		0.27 (0.33)			0.26 (0.29)	
Finance Minister Index			0.14 (0.15)			0.12 (0.16)
(Implementation)	0.28***	0.25***	0.26***	0.08	0.08	0.07
Economic growth	(0.09)	(0.09)	(0.09)	(0.11)	(0.11)	(0.11)
	−0.17***	−0.17**	−0.16**	−0.10	−0.13	−0.07
Unemployment	(0.06)	(0.08)	(0.07)	(0.07)	(0.10)	(0.07)
R^2	0.27	0.24	0.25	0.05	0.05	0.06
N	50	50	50	50	50	50

Note: Significance levels: <0.01=***, 0.01–0.05=**, 0.05–0.10=*. White heteroskedasticity consistent standard errors in parentheses.
Source: Yalloutinen (2004) and own elaboration.

Table 7 presents results for the latter period (1998–2002) when the budget process indexes are included in the regression simultaneously. The results are very different compared to the earlier period. The coefficients have correct signs and they are statistically significant.

Table 7 Institutions and fiscal policy in the CEECs (OLS): 1999–2002

	Dependent variable
	Budget balance
Constant	−5.81*** (1.81)
Finance Minister Index (Decision)	0.59** (0.23)
Parliament Index (Legislative)	−0.54** (0.26)
Finance Minister Index (Implementation)	1.34*** (0.36)
Economic Growth	0.59*** (0.12)
Unemployment	−0.17* (0.09)
R^2	0.53
N	40

	Dependent variable			
	Budget balance			
	(1)	*(2)*	*(3)*	*(4)*
Constant	−8.81*** (1.56)	−3.92** (1.72)	−4.92*** (1.14)	−7.50*** (1.60)
Finance Minister Index (Decision)	0.76*** (0.26)			
Parliament Index (Legislative)		−0.61** (0.28)		
Finance Minister Index (Implementation)			0.64*** (0.18)	
PEP				0.31 (0.20)
Economic growth	0.49*** (0.10)	0.57*** (0.13)	0.56*** (0.12)	0.53*** (0.12)
Unemployment	0.09 (0.09)	0.05 (0.09)	−0.23** (0.11)	0.05 (0.10)
R^2	0.34	0.28	0.37	0.24
N	40	40	40	40

Note: Significance levels: <0.01=***, 0.01–0.05=**, 0.05–0.10=*. White heteroskedasticity consistent standard errors in parentheses.

Source: Yalloutinen (2004) and own elaboration.

Overall, these results lend support to the notion that countries with more centralised fiscal institutions have enjoyed a better fiscal discipline. In other words, it seems that strong finance ministers have enhanced fiscal rigour thus complementing the commitments imposed by jointly negotiated targets. All the stages of the budget process have been important. These results apply to the latter period only because there is no evidence for the earlier period. As the number of years considered is small and there is a lack of extensive fiscal data, the results should be treated with caution.

The results in Table 6 suggested that indexes could not explain the differences in the fiscal performance in the CEECs during the first part of the period. As explained by Yalloutinen (2004), this could be due to the reliability of data and/or the transition process which had a significant impact on the behaviour of public finances in the CEECs. In any case, the results for the earlier period are in a striking contrast to the results in Gleich (2002) who found that fiscal institutions did have a significant effect on fiscal performance in the CEECs during 1994–1998.

Therefore, it is interesting to compare how well different indexes fare when the latter period is analysed. This is done in Table 8 where results from the lower part of Table 7 (column A) and regression results obtained by using alternative indexes as explanatory variables are combined. The figures in column (B) have been obtained by using the institutional data from Yalloutinen (2004) but the indexes are formed by using the coding rules from Hallerberg et al. (2001). The coding rules used in both studies do not differ substantially, and therefore there should not be major differences between the results.[8] Finally, column (C) includes results obtained by using indexes from Gleich (2002).[9]

Table 8 Institutions and fiscal policy in the CEECs, 1999–2002: comparison of alternative studies

	Dependent variable – Budget balance								
	Hallerberg (2001) (B)			*Gleich (2002) (C)*			*Yalloutinen (2004) (A)*		
	(1)	(2)	(3)	(1)	(2)	(3)	(1)	(2)	(3)
Constant	−8.66*** (1.63)	−3.98*** (1.42)	−4.92*** (1.14)	−7.03*** (1.73)	−5.89*** (1.43)	−8.91*** (1.78)	−8.81*** (1.56)	−3.92*** (1.72)	−4.92*** (1.14)
MFD	0.65** (0.26)			0.35 (0.33)			0.76*** (0.26)		
PL		−0.79*** (0.25)			0.06 (0.16)			−0.61 (0.28)	
MFI			0.64*** (0.18)			0.70*** (0.29)			0.64*** (0.18)
GROWTH	0.51*** (0.11)	0.52*** (0.11)	0.56*** (0.12)	0.49*** (0.11)	0.52*** (0.12)	0.43** (0.09)	0.49*** (0.10)	0.57*** (0.13)	0.56*** (0.12)
UNEMPLOY	0.07 (0.09)	0.08 (0.08)	−0.23** (0.11)	0.03 (0.10)	0.03 (0.10)	−0.02 (0.10)	0.09 (0.09)	0.05 (0.09)	−0.23** (0.11)
R^2	0.30	0.37	0.37	0.24	0.21	0.30	0.34	0.28	0.37
N	40	40	40	40	40	40	40	40	40

Note: Significance levels: <0.01=***, 0.01–0.05=**, 0.05–0.10=*. White heteroskedasticity consistent standard errors in parentheses. Period: 1999–2002. Figures in (A) obtained by using indexes and coding rules from this study; figures in (B) obtained by using indexes formed based on institutional data from this study and coding rules from Hallerberg et al. (2001); figures in (C) obtained by using indexes from Gleich, (2002). MFD=Finance minister index (Planning and decision-making stage), PL=Parliament index (legislative stage), MFI=Finance minister index (implementation stage).

As expected, the results between (A) and (B) are very similar. Interestingly, the coefficients for the Finance Minister Index (Decision) and the Parliament Index (Legislative) in (C) are not statistically significant, and the coefficient for the Parliament Index is almost zero. The exception is the Finance Minister Index (Implementation) for which the coefficient has a correct sign and is statistically significant.

The main difference between the indexes in Yalloutinen's study has not been considered in Gleich's study (and vice versa). Some features of the fiscal institutions are included in both set of indexes but the information itself obtained in Yalloutinen's work (2004) is, in some cases, different from that included in Gleich's (2002). The results in Table 9 suggest that much care should be taken when this research strategy is adopted as the final outcomes are clearly sensitive to the way the indexes are formed. This applies both to the decision on what features of the fiscal institutions are the most relevant and should thus be included in the indexes and also to the quality of the institutional data.[10] The analysis undoubtedly also suffers from a lack of historical and fiscal data. Only the passing of time will remedy this problem.

5 Conclusion

New Member States have joined the EU, and all have gone through slight processes of adaptation of their budgetary procedures aimed at improving their capacity to achieve fiscal discipline. These institutional improvements are promising for the future of the single currency and the aggregated fiscal performance in the Euro zone.

This paper has presented the existing evidence that point to a positive relationship between centralisation and healthy public finances. Centralisation has been promoted in the CEECs through a commitment approach to budgeting (almost forgetting the alternative delegation approach). Besides the traditional empowerment of the finance minister, the experience from the EU-15 indicates that the strengthening of commitment elements must also be accompanied by complementary measures, such as the proliferation of multi-annual budget plans. Both sets of measures have proved very effective for the sustainability of fiscal consolidation and long-term fiscal discipline. Once the EU-15 countries have taken the lead in this type of institutional reform, new Member States should be encouraged to keep moving in this positive direction.

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Notes

[1] Among these factors those most studied in the literature have been: the influence of the cabinet's ideology on fiscal policy (Mulas-Granados, 2003a; Perotti and Kontopoulus, 2002); the influence of the electoral system and the budget process (Hallerberg and Von Hagen, 1997; Persson and Tabellini, 1999; Von Hagen et al., 2001), as well as the proximity of elections (Alesina et al., 1992; Maroto and Mulas-Granados, 2001). Finally, the degree of fragmentation in decision-making and its effect on the budget has been also widely studied (Grilli et al., 1991; Mulas-Granados, 2003a; Roubini and Sachs, 1989).

[2] Both Lithuania and Poland have also introduced changes in other stages of the budget process.

[3] Some elements of the empirical evidence presented in this section are based on the assessments by Gleich (2002), Martinez-Vazquez and Boex (2000) and Yalloutinen (2004).

[4] This is, strictly speaking, different from simply using the index values in the analysis since the index values do not automatically translate into different forms of fiscal institutions.

[5] For example, Hallerberg et al. (2003) form separate indexes for the commitment and delegation status. The index for commitment states emphasises the fiscal targets and the multi-annual frameworks (and the implementation stage of the budget process is not considered at all). The index for delegation states, in turn, describes the relative powers between the finance minister and spending ministers during the decision-making and implementation stages of the budget process.

[6] Another more practical reason for not forming separate indexes for commitment and delegation status is simply that there would not be much variation especially in the commitment index. The coverage and degree of commitment of fiscal targets are rather uniform across countries and the multi-annual frameworks could not be considered due to insufficient experience of them. Further limitation comes from the fact that only one country is coded as a delegation state for the latter period.

[7] The PEP index was not included in these regressions because the pre-accession programmes were not drafted during this period.

[8] Note that the Finance Minister Index (Implementation) – MFI index – is the same between (A) and (B).

[9] Gleich's study also included index values for the latter period but at the time there were insufficient years to test them. Note also that in Gleich's study, increase in the Parliament Index (Legislative) – PL index – means that the parliament's power relative to the government is smaller.

[10] The institutional data in these types of studies are in most cases based on questionnaires completed by country authorities. The inherent difficulty with this approach is that it is difficult to verify the correctness of the replies.