

Who Decides the Budget?

A Political Economy Analysis of the Budget Process in Latin America. An Overview

Carlos G. Scartascini*
Research Department
Inter-American Development Bank

* Based on joint work with Ernesto Stein. Project financed by IDB and DFID.
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The Budget Process

- The budget is the main tool for allocating scarce public resources.
- Budget decisions are the result of a **collective process** involving a variety of political actors, each with their own motivations and **incentives**.
 - Legislators may have the incentive to bring benefits to their district.
 - Line Ministers could be interested in fostering public projects in their area of domain.
 - The President may be interested in increasing expenditures before the election to boost his popularity.

The Budget Process

- Given the prevailing preferences of the participants, under some institutional arrangements, the budget process may lead to a number of potential problems
 - Electoral budget cycles
 - Expenditures higher before the election; increases in debt; fiscal tightening after elections, etc.
 - The common pool problem
 - Over utilization of resources leads to higher expenditures, higher debt, etc.
 - Rigidities
 - Political actors try to shield (favor) themselves from the results of the budget process

The Budget Process

- The budget process is a political process, and as such it cannot be fully understood without sound political economy analysis.
- There is an ample Public Choice and Political Economic literature that looks at the impact of political institutions on fiscal outcomes.
- The studies have usually looked at:
 - Political business cycles
 - Impact of political institutions on fiscal outcomes
 - Impact of budget institutions on fiscal outcomes

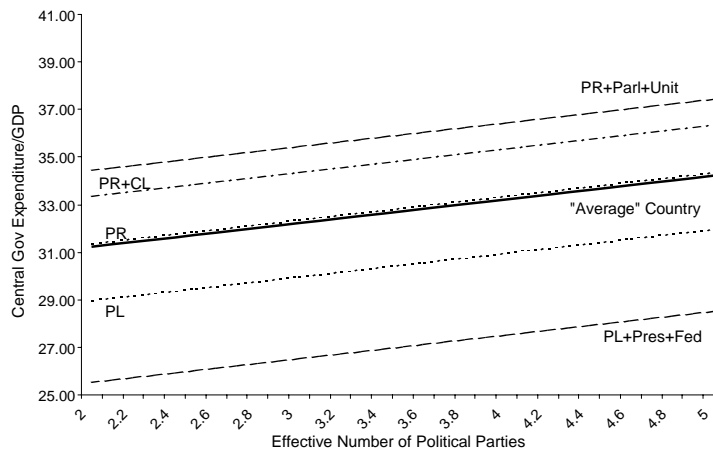
Explaining Fiscal Outcomes Political Institutions

- For example, some of the studies on political institutions have looked at the impact of:
 - Political regimes type (Persson-Tabellini 2000-2003, Cheibub et al 2006, A. Neto and Borsani 2004, etc)
 - Electoral systems (Milessi-Ferreti et al 2002, P-T 2003, Perotti et al 2002, Scartascini and Crain 2002, Hallerberg and Marier 2004)
 - Role of the cabinet (Kontoupolos and Perotti 1998, Bawn and Rosenbluth 2002)
 - Federalism (Stein 1998, Rodden and others 2002, Gibson and others 2004)
- These variables have helped to explain:
 - The size and composition of government expenditures
 - The levels of deficit and debt
 - The levels of tax revenues.

Explaining Fiscal Outcomes. Electoral Systems

- The “Electoral institutionalists” focus their analysis on the effects that electoral systems have either directly or indirectly on the budget process.
- Most of this literature, which concentrated its focus on the size and composition of government expenditures, developed around the concept of the “commons problem”.
- In general, proportional representation has been found to generate larger governments than plurality systems
 - The graph shows the fitted values of the regressions for different levels of the effective number of parties given the institutional framework of each country for a world sample of countries in the period 1980-1996

Explaining Fiscal Outcomes. Electoral Systems



References: PR: Proportional representation; PL: Plurality; CL: Closed lists;
Parl: Parliamentary regime; Pres: Presidential regime; Fed: Federal; Unit: Unitary

Source: Scartascini and Crain (2003)

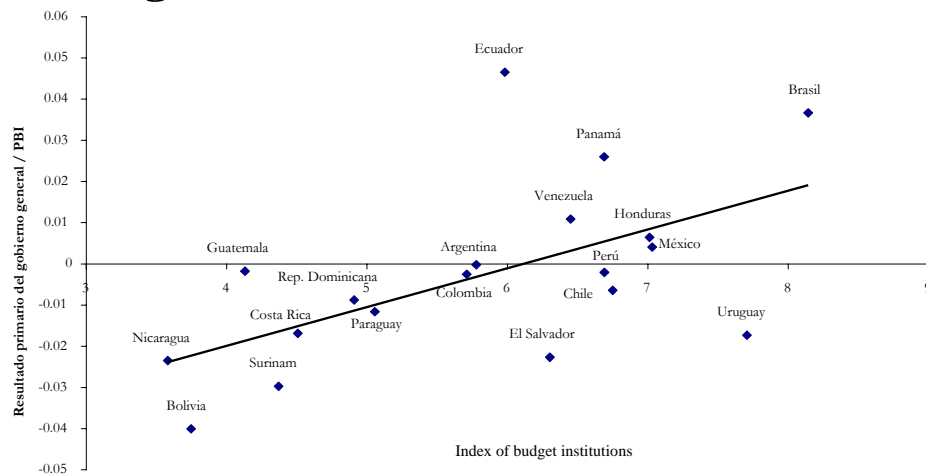
Explaining Fiscal Outcomes. Budget Institutions

- The “Budget institutionalists” focus their analysis on the impact of budget rules and regulations.
- They argue that deficit may be restricted by introducing limits to the outcomes of the process and providing greater power in budget negotiations to those with incentives to keep finances under control.
- Therefore, a more hierarchical (or more centralized) and more transparent budget process, along with constraints on the deficit could lead to greater budget discipline.

Explaining Fiscal Outcomes. Budget Institutions

- The evidence gathered by the literature on budget institutions indicates that stricter numerical limits, higher prerogatives to the actors with incentives favoring fiscal restraint, and higher transparency tend to generate more sustainable fiscal results.
 - For the **US**: Eichengreen (1992), Bohn and Inman (1995), Alt and Lowry (1994), Poterba (1994), Bayoumi and Eichengreen (1996)
 - For **Europe**: Von Hagen (1992) and von Hagen and Harden (1995), Hallerberg and others (2001)
 - For **Latin America**: Alesina et al (1996), Stein et al (1998), Filc and Scartascini (2006, 2007).

Explaining Fiscal Outcomes. Budget Institutions



Source: Scartascini and Filc (2005)

Explaining Fiscal Outcomes. Budget Institutions

- More recent research has blended both strands of research providing additional insights on how budget institutions work under different political frameworks (Hallerberg and Marier 2004)
- The research on budget institutions has had an important impact on institutional reforms, which have flourished in Latin America in the last decade .
 - As it can be observed in the next Table, most Latin American countries engaged in extensive reforms, particularly starting in 2000.
 - For example, 7 Latin American countries approved Fiscal Responsibility Laws.

Explaining Fiscal Outcomes. Budget Institutions Reform since 1990

Table 5.1 Summary of fiscal reforms in Latin America

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Argentina		N, F			U, E ¹						R(N,C,T), SP, r(c), S, E, F ² , r(n), S					R(N,S,C)
Bolivia				S								U				
Brazil								N			R(N,S,T), P					
Colombia		r ³			F ⁴	C					N	S				R(N,P,T)
Chile											R ⁵ (N,C)			e ⁶ , T		
Costa Rica												U, A				
Ecuador						U		E ⁷	N	C			R(N,P,C,T)		T	r(n)
El Salvador			U				A									
Guatemala											P, N, U					
Honduras															P, U	
Mexico									C				C ⁸ , P, T			
Nicaragua													S, F ⁹ , A			P
Panama									U				R(N), S, T			r(n), P, U
Paraguay			e ¹⁰								U			P		p ¹¹
Peru					U						R(N,P,C,T)		r(n), C, T			
Dominican Rep									P ¹²							T
Uruguay							U, E ¹³									
Venezuela									C, U		P					R(N) ¹⁴

Notes:

N: Numerical rules; C: Contra-cyclical Fund; P: Multiyear framework; R: Fiscal Responsibility Law; Subnational Govts; U: Single account; E: Increase in Executive power; F: Increase in power of Finance Ministry; T: Transparency, and; A: Principles of transparency.

Italic lower case means that the previously established reforms were reversed or the restrictions weakened.

R(X,Y) means that the Fiscal Responsibility Law included restrictions to X and Y.

Source: Filc and Scartascini (2007)

The Pol. Econ of the Budget Process Towards a New Framework

- Still, the traditional literature has important limitations, particularly when dealing with policy recommendations.
- Therefore, it is important to develop a framework that takes into account the incentives of the actors (in a general equilibrium perspective) participating in the political process in which the budget process is embedded.

Towards a New Framework. Limitations of the literature

- So far, most empirical studies involve cross-section analysis, and do not engage in a detailed discussion of the particular institutional context within which the players play the game
 - It's essential to know who the players are and which are their incentives at each stage of the budget process, otherwise, the reforms may generate even worse outcomes.
 - For example, as it happened after the elimination of the “parliamentary assistances” (“auxilios parlamentarios”) in Colombia in the ‘90s.

Towards a New Framework. Limitations of the literature

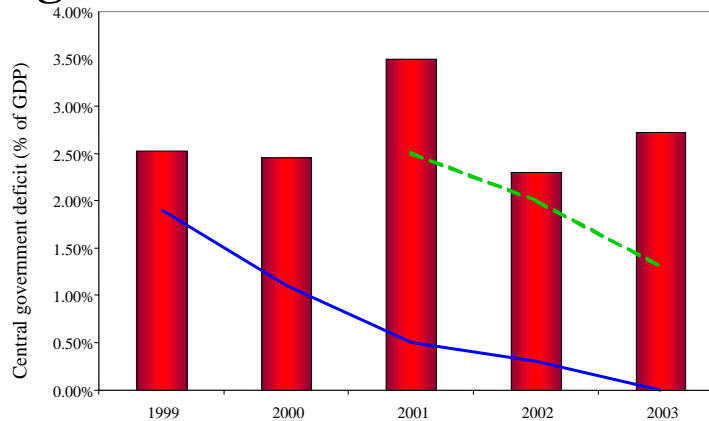
Unintended consequences of a reform: The case of the
“auxilios parlamentarios” in Colombia.

POLIT. INSTIT. AND POLIT. TRANSACTIONS	REFORM	OBJECTIVE	UNINTENDED CONSEQUENCES (?)
<p>Political Institutions: Fragmented party system. President with low partisan power.</p> <p>Game of political transactions: The President has to negotiate key votes with legislators.</p> <p>Result: The “auxilios” are the currency used by the Executive to buy the necessary support in Congress.</p>	<p>The elimination of the “auxilios parlamentarios”. (Constitutional Reform)</p>	<p>To reduce the discretionary funds in hands of the legislators.</p>	<p>Banning the “auxilios” increased the transaction costs, as prices were no longer predetermined and legislators could claim even larger amounts for their votes.</p> <p>By 1998, the transfers were higher (x 3), less transparent and more discretionary.</p>
<p>Source: Scartascini and Filc (2007) based on Vargas (1999), Echeverri, et al (2004) and others</p>			

Towards a New Framework. Limitations of the literature

- The traditional literature focuses more on *formal rules* of engagement between the players, rather than *actual practices* that shape the budget process.
 - Numerical rules are not complied with (e.g., FRL in Argentina and Peru);
 - Actors surpass (de facto) their granted prerogatives (e.g., budget estimates in Bolivia or reallocation of expenditures in Ecuador)
 - Actors do not play the role they are supposed to (e.g., Congresses and Supreme Audit Agencies in most countries).
 - Chile has followed a “rule” better than anybody else (even though it wasn’t part of a formal law for the first few years).

Compliance with Fiscal Rules: Argentina



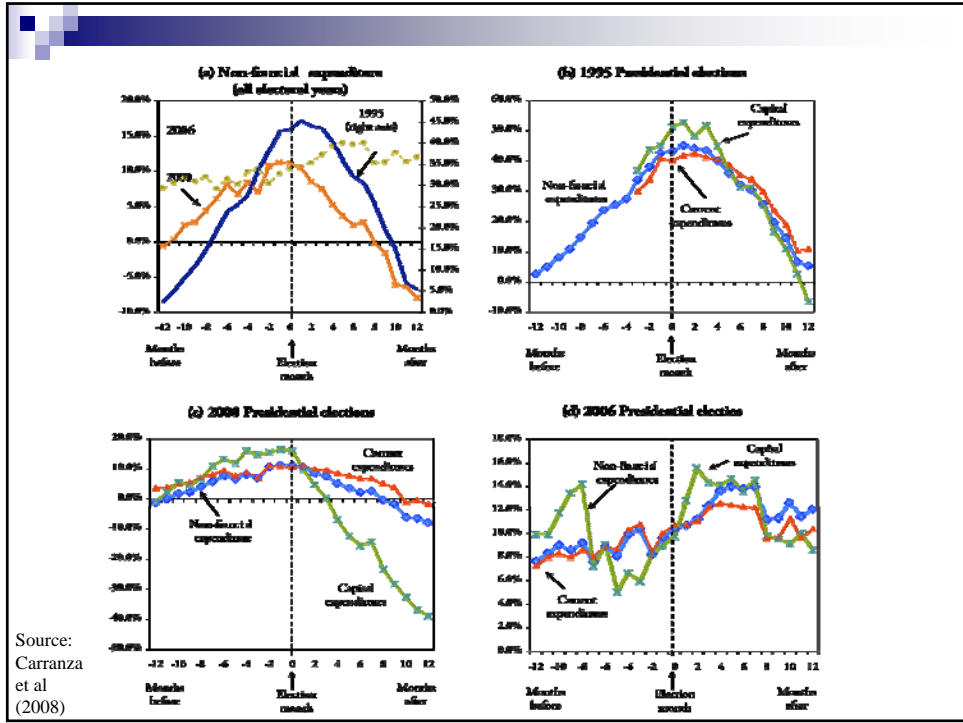
Source: Braun and Tommasi (2005), Filc and Scartascini (2006)

■ Actual central government deficit
- - - Deficit limit according to 2001 Fiscal Solvency Law
— Deficit limit according to 1999 Fiscal Solvency Law

Note: The Law was replaced in 2004

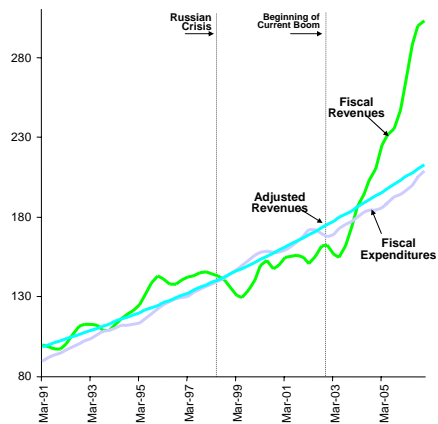
Compliance with Fiscal Rules: Peru

- In Peru, the numerical rules component of the FRL has only recently been complied (partially) with.
 - It complied with the “easy” part: reducing the deficit during booms.
 - It complied with the “not so easy” part: reducing electoral cycles (but during a cycle with no president seeking reelection)
 - Did not comply with the “hard” part: keeping expenditures from increasing beyond the limits in the law (GDP growth plus 3%)
 - Other aspects of the law (e.g. multi-annual macro program, increased transparency and budget cycle) have positively changed the dynamic of the budget discussions.

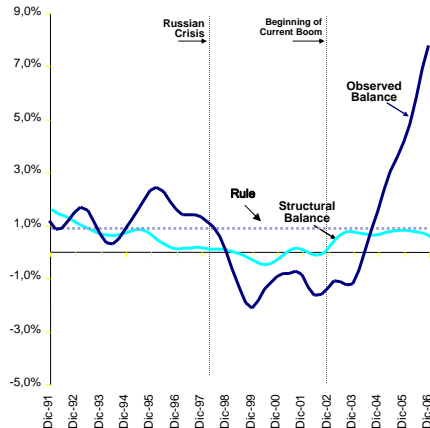


Compliance with Fiscal Limits Chile's Structural Fiscal Balance

Fiscal Revenues and Expenditures
(Fiscal Revenues, Mar-91 = 100)



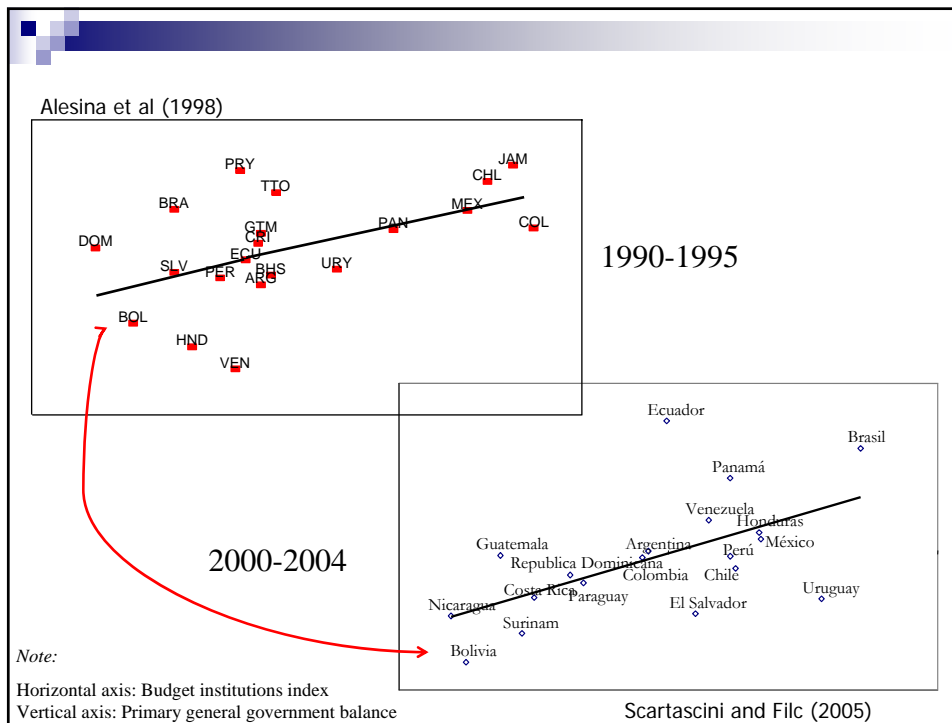
Fiscal Balance
(% of GDP)



Source: Talvi, Ernesto (2007), "If Latin America Were Chile: A Note on Structural Fiscal Balances".

Towards a New Framework. Limitations of the literature

- In general, they cannot help understand why some reforms work (or are adopted) in some countries, but not in others.
 - For example, despite sustaining large fiscal imbalances for a long period, Bolivia did not modify their budget institutions despite the wave of reforms in the neighboring countries.



Towards a New Framework. Limitations of the literature

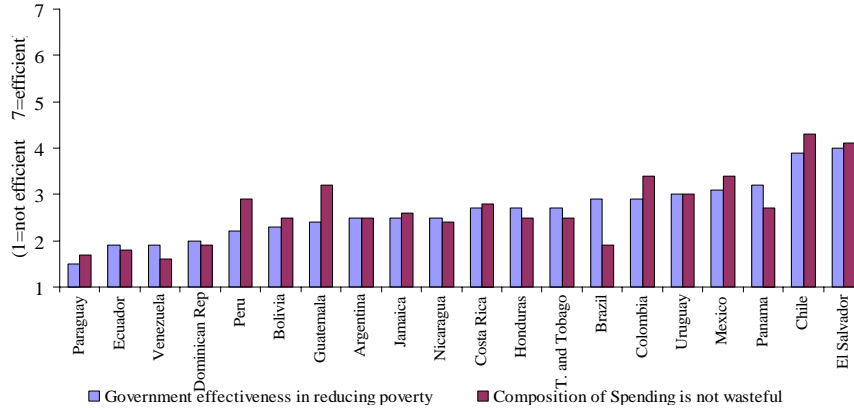
- They do not help to understand:
 - why some countries pass certain reforms, when the fiscal fundamentals have not changed;
 - the strategic use of the budget rules for gaining power in the political process
 - E.g., presidential “superpowers” in Argentina.

Towards a New Framework. Limitations of the literature

- They tend to focus exclusively on outcomes linked to fiscal sustainability, leaving aside other interesting dimensions, such as efficiency and representativeness.
 - While fiscal balances have improved in Latin America, people is relatively unhappy with the allocation of expenditures, which explains part of the disenchantment with the results of democracy.
 - Most people think that the allocation of spending is wasteful and improvements have not been correlated to improvements in the fiscal balance.

Additional Measures of Fiscal Performance

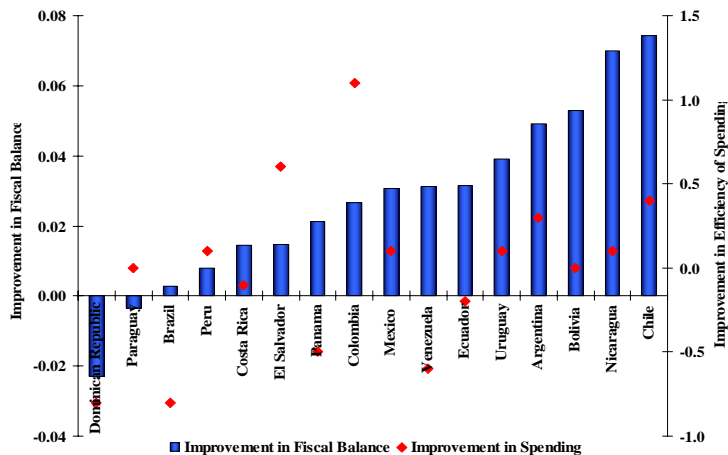
Government Efficiency Fighting Poverty and Composition of Government Expenditures



Data source: GCR (2005 and 2006)

Additional Measures of Fiscal Performance

Change in Fiscal Balance and Efficiency of Spending (2001-2006)



Data source: GCR (2001 and 2006) and WEO (2001 and 2006)

Additional Measures of Fiscal Performance

- Traditionally, the studies have focused on simple rules (so they are not subject to manipulation) and the impact on easily available measures of fiscal outcomes.
- However, that approach may misguide the analysis of the actual impact.
 - For example, compare current fiscal balance vs. structural balance

Additional Measures of Fiscal Performance

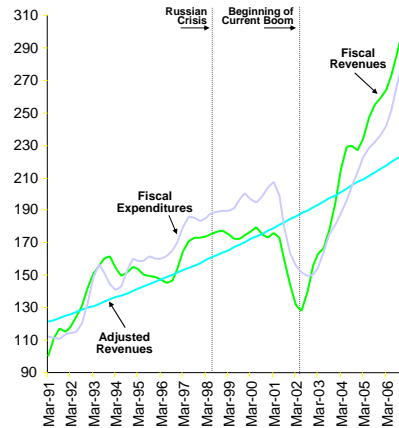
- In Argentina it took several years (and reforms) to finally comply with the (several times revised) FR Law.
- However, past bad performance might have been deceiving ...
- ... as well as current good performance

Compliance with Fiscal Limits

Argentina: Structural Fiscal Balance*

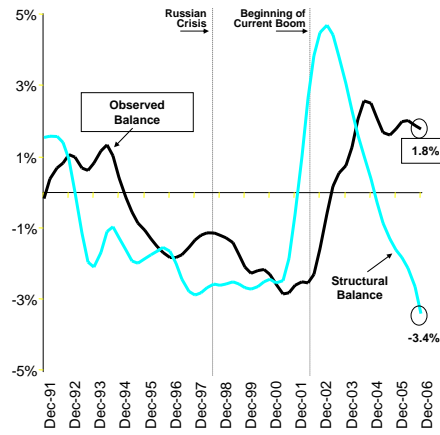
Fiscal Revenues and Expenditures

(Fiscal Revenues, Mar-91 = 100)



Fiscal Balance

(% of GDP)

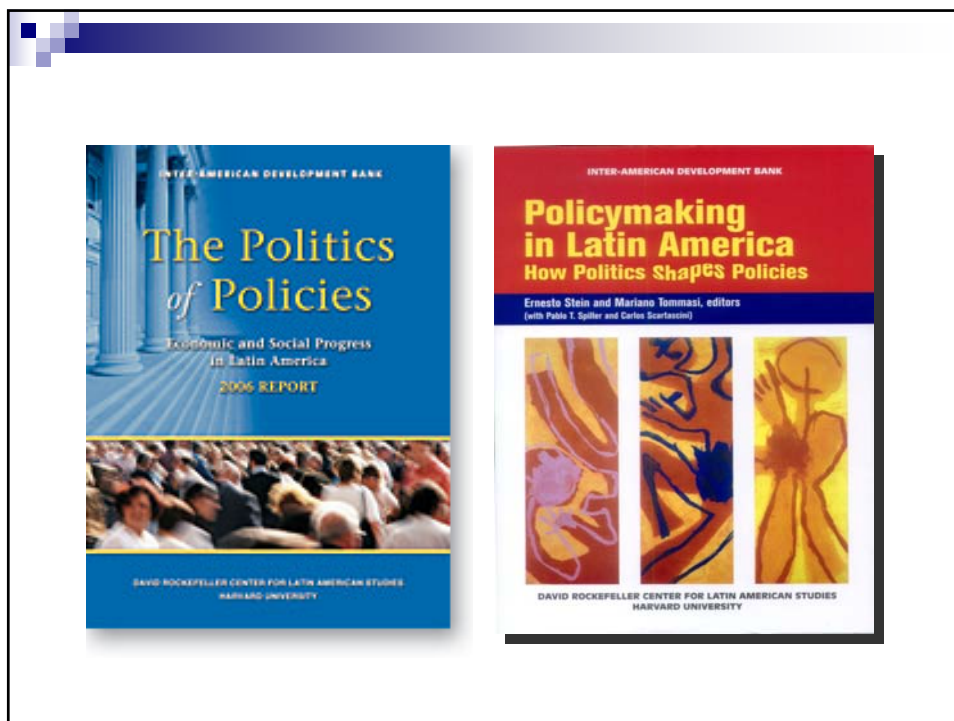


* Izquierdo, Ottonello, Talvi (2007), "If Latin America Were Chile: A Comment on Structural Fiscal Balances and Public Debt".

Towards a New Framework.

Specifics of the Project

- In a joint project that involved several IDB departments, 9 country studies were commissioned for:
 - Argentina, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela
 - These papers complement an earlier paper for Bolivia.
- The project (and the framework) complements the work on the policymaking process (PMP) pursued at the IDB



Towards a New Framework. The Content of the Project

- Studies focus on individual countries, but within a broader comparative project, and using a common framework.
- The institutional set-up of the budget process in each country is studied in great detail.
- The authors of the country papers go to great lengths to describe the key actors, their incentives, the institutional determinants of these incentives, as well as the way the game is played.

Towards a New Framework.

The Content of the Project

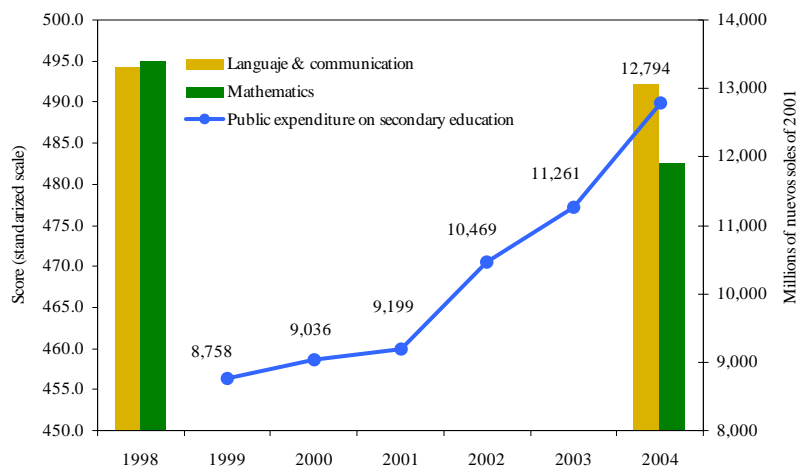
- Pay attention to actual practices, looking beyond the written rules.
- The studies understand the incentives of actors from a general equilibrium perspective
- Throughout the analysis, the authors are aware of the key role that the budget process may play in the broader policymaking game, as a crucial arena in which key political transactions take place:
 - Funding for any policy has to go through the budget
 - May play a role in helping governments build coalitions (e.g., Brazil)
 - May help to compensate losers who may otherwise block important policy initiatives.

Towards a New Framework.

The Content of the Project

- They focus on fiscal sustainability, but also on other outcome dimensions such as efficiency, budget rigidity, and the degree to which allocation reflects the preferences of the population.

Add. Measures of Fiscal Performance Education Expenditure and Quality in Peru



Towards a New Framework. The Content of the Project

- They use detailed budget data corresponding to each stage of the budget process to substantiate their claims regarding the interaction between the different players.
- The agents play a sequential game, therefore, the influence of the actors can only be evaluated after taking into account the role they effectively play at each stage of the budget process.
 - For example, Congress may not be that powerful after all if the changes it introduces during approval can be reverted by the Executive during execution.

Detailed Budget Data. Indices of Budgetary Change

- For example, to measure change at each stage we use the following indicator
- [1] Stage 1: , for each year

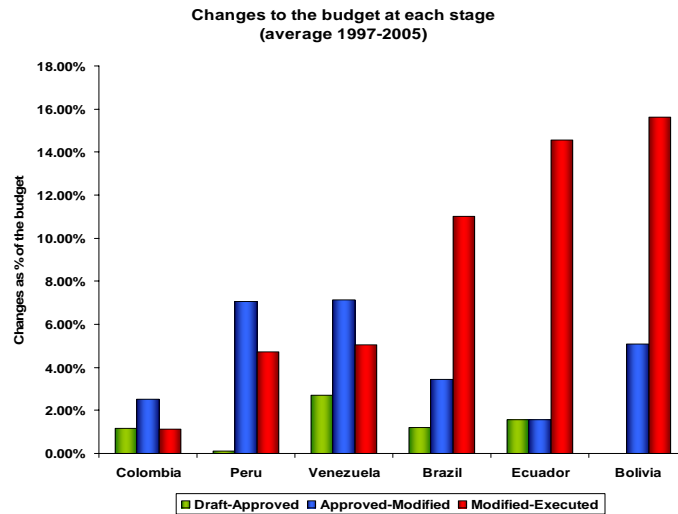
$$C_{BL} = \frac{\sum_{i=1}^N |B_i - L_i|}{2}$$

- Where:
- B_i : is the participation of item i in total spending presented in the Executive budget proposal.
- L_i : is the participation of item i in total spending approved in the budget law.
- The coefficient CBL represents the yearly changes in the composition of spending in the approval phase
- Similar coefficients are used for the other stages

Detailed Budget Data. Indices of Budgetary Change

- These indicators help us to understand:
 - Where do changes take place
 - Which actors (according to their role in the process) have more influence
 - Whether budget execution is close to the original spending plans (and hopefully to original careful planning).
 - The graph shows that in most of the countries in Latin America, Congress has a minor role and the changes it introduces can generally be reverted by the Executive during execution.

Detailed Budget Data. Indicators of Budgetary Change



Detailed Budget Data. Indicators of Budgetary Change

- The Table shows changes to the budget in Bolivia. The budget law (Appr) is modified during the year (Mod) and final appropriations (Acc) for each Ministry differ greatly from the original and modified laws.

	2001	2002	2003	2004	2005	2006
Education Ministry						
Mod/Appr	184%	191%	126%	163%	204%	148%
Acc/Appr	126%	97%	73%	96%	136%	59%
Health Ministry						
Mod/Appr	124%	124%	120%	154%	180%	121%
Acc/Appr	87%	91%	83%	109%	127%	58%
Labor Ministry						
Mod/Appr	132%	112%	128%	106%	116%	109%
Acc/Appr	117%	63%	111%	93%	92%	58%

Source: Scartascini and Stein (2005, 2008). Data from ILACO-Bolivia.

Towards a New Framework. The Content of the Project

- In some cases, the studies try to explain dynamics of institutional change
 - why some reforms take place and others don't
 - why some changes in formal rules may not change actual behaviors
 - why inefficient arrangements persist

The Content of the Book

- The book includes an overview and conclusions chapter and the ten country studies.
 - Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, and Venezuela
- Most of the country chapters (which have already been published as IDB working papers) are ready.
- We hope to have it published before the end of the year.