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Book Reviews

European Budget Institutions

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Mark Hallerberg, Domestic Budgets in a United Europe: Fiscal Governance from the End of Bretton Woods to EMU *(Ithaca, NY: Cornell University Press, 2004). 245 pp., $39.95 (hardbound), ISBN: 0801442710.*

James D. Savage, Making the EMU: The Politics of Budgetary Surveillance and the Enforcement of Maastricht *(New York: Oxford University Press, 2005). 256 pp., $85.00 (hardbound), ISBN: 0199278407.*

In 1992, the member countries of the European Community signed the Maastricht Treaty, which included provisions to harmonize fiscal policies in support of a new common currency, the euro. The signatories were inspired enough to pledge themselves to budgets that were "close to balance or in surplus." But following further negotiations that produced the Stability and Growth Pact, the countries' fiscal policies were targeted to two reference values: deficits not to exceed 3 percent of gross domestic product and debts not to exceed 60 percent of gross domestic product. By 1998, the European Union (EU) decided that all but one of the countries interested in joining the European Monetary Union (EMU) had met these targets or had made sufficient progress toward the debt ceiling. By 2000, the median balance of the EMU countries' budgets was in surplus rather than deficit, though much of this result was probably the result of boom-time economic growth.

Whether the treaty's provisions would bind over the long run was another matter. As the leader of the Italian government during the accession phase, Romano Prodi advocated policies that helped the typically spendthrift Italian government join the monetary union, a result that surprised most observers. But as president of the European Commission in 2002, he criticized as "stupid" the rigidity of the pact, which, if implemented fully, would place financial penalties on countries that exceeded deficit limits during periods of slow growth or even mild recession. In my opinion, Prodi was right: When a country gives up its ability to reduce interest rates during a recession, it must rely on fiscal policy to stabilize the national economy—but that is not easy. From this perspective, and recognizing the power of large countries in political negotiations, it is understandable that the Council of Economic and Finance Ministers voted in 2003 not to penalize France and Germany for exceeding the targets and further weakened the rules in 2005; at present, about half the countries in the EU are running excessive deficits without formal penalty.

As one might expect, European public finance experts have been fixated on these and related developments. Most American experts, in contrast, have been mildly interested at best. The institutional features of Europe—parliamentary systems and a supranational fiscal authority—seem remote for the United States. But Americans should pay more attention, and not only because of the general importance of Europe to the world economy. Both of the books reviewed here illustrate the importance of understanding the different contexts and sequences of institutional development and thereby serve as an important corrective to simplistic models of budget institutions. And for those who enjoy speculation, the books suggest some institutional approaches that could be considered in the United States.

Mark Hallerberg's *Domestic Budgets in a United Europe: Fiscal Governance from the End of Bretton Woods to EMU* examines the budget processes in Western European countries from 1973 to 2000. Though the book takes as its point of departure how the countries were successful in meeting the deficit ceiling, it is really devoted to explicating a general model of budgetary institutions. It frames budgetary policy making as some advocates of the Stability and Growth Pact have done: as a common-pool resource problem. Within Europe, a country might borrow enough to place inflationary pressures on the common currency but pay no penalty because of the moral hazard opportunity in a union. Within a country, representatives of local interests face the same temptation to shift the burden to others. Hallerberg identifies the worst case of fiscal governance as the "fiefdom" form, in which the preferences of spending ministers routinely matter more than those of their party, a situation that, over time, threatens a country's fiscal stability.

Public choice economists have suggested different remedies for this problem, such as fiscal and currency rules that remove discretion from governments and centralizing authority within the executive branch. Hallerberg cites some influential work in the latter vein, particularly by the Inter-American Development Bank (a remarkable line of argument given the relatively recent history of dictatorship in many Latin American countries). But he goes far beyond the simple recommendation to "centralize," following the lines of his earlier work with Jürgen von Hagen (who has been very influential in European fiscal governance); in *Domestic Budgets,* he presents a sophisticated model of how governments can develop forms of fiscal governance that are consistent with their other institutional characteristics.

Central to this model are party systems, which are a joint function of electoral rules (different forms of proportional representation or "first past the post") and political cleavages. Some party systems typically produce majority governments, and when these governments are subject to electoral competition, voters can blame them for imprudent budgets. Consequently, they have a strong incentive to delegate authority over the budget to a powerful minister. In the United Kingdom, for example, the chancellor of the exchequer has tremendous influence over the budget.

The party systems in some other countries enable more than two parties to win seats in parliament, typically forcing the leading parties to enter coalitions in order to form a government. But here, the delegation strategy is dangerous for all parties in the governing coalition except that of the finance minister, for this minister is likely to favor his party in daily decisions. Better than delegation, then, is a system in which each party commits to a budget agreement prior to the formation of the government—a contractual program that sets out budget allocations for the expected life of the government and rules for making adjustments after unexpected events. In this way, the multiple governing parties can avoid the risks of fiefdom behavior. The Netherlands offers an ideal example of this approach.

Hallerberg applies and fine-tunes this model over a period of nearly 30 years in 15 countries. Although the book includes a minimal formal model and a little quantitative analysis, its strength is in its description of institutional and political details, based in part on extensive interviews throughout the capitals of Europe. A revelation of this approach is that it is a serious mistake to focus on European treaties: Though the Stability and Growth Pact apparently did influence some countries to make decisions they probably would have avoided otherwise, the evolution of budgeting in most countries followed a domestic logic. For example, in Sweden and Denmark, which routinely have minority governments, fiscal stress led to institutional innovations that mixed aspects of delegation and commitment models. In Germany, which tends toward delegation, institutional limits on the finance ministry hindered its performance, as was shown by its exclusion from the decisions about folding East Germany into West Germany. In commitment states such as Netherlands and Belgium, coalition agreements were enabled by outside bodies intriguingly named the Study Group of the Budget Margin and the High Council of Finance, respectively.

If you are worried about the trend in U.S. budgetary policy, you may wistfully dream of similar commitment bodies in the United States—for example, by resurrecting "budget summits," one of which contributed to the deficit reduction of 1990. By extending Hallerberg's model (an exercise that is admittedly beyond its intended scope), one might also ask, why did the United States make such a quick transition from large surpluses to large deficits? Was it because of the absence of an institutionalized commitment mechanism? Or did the United States, particularly with a majority party that unified control of the presidency and the Congress beginning in 2001, and a very competitive party system, fail to delegate authority to the Office of Management and Budget (OMB) and the budget committees to act as fiscal guardians? That neither commitment nor delegation occurred—and the fact that many European countries are now running "excessive" deficits—may instead suggest that party competition is not a sufficient condition to produce fiscal prudence. Hallerberg's theory might be improved by incorporating the insights of Aaron Wildavsky and others about the presence or absence of budgetary norms.

Another interpretation of U.S. policy is that despite the appearance of unified government, in reality, there are numerous "veto players" with different budgetary preferences who kill all potential deficit-reduction agreements. Hallerberg challenges this interpretation for Europe, as many countries developed internal mechanisms for cooperation that were supported for a while by the external prod to meet deficit requirements. An enchanting example from Finland is the prime minister's "evening school," in which ministers would talk informally in the sauna and then over drinks. Alas, the similar "Board of Education" of U.S. Speaker of the House Sam Rayburn is long past (and I wonder how many Americans would want to imagine their leaders in a sauna). But the United States might import another Scandinavian product—in this case, Sweden's two-part budget process, which features a spring debate on the totals and major budget functions ("frames" in Sweden) and a fall debate on finer details. Similarly, the United States' concurrent budget resolution could be converted to a joint budget resolution and budget functions rationalized with committee jurisdictions—both major changes, to say the least.

James Savage's *Making the EMU: The Politics of Budgetary Surveillance and the Enforcement of Maastricht* places European institutions at the center of the analysis. The European Commission was given the task of keeping track of countries' fiscal conditions, and member countries took actions to be able to join the EMU and avoid penalties afterward. Those actions were a mix of policy changes and accounting gimmicks—but only some of the accounting gimmicks worked because of the rulemaking process that is the focus of this book.

Treaties are rarely self-enforcing—they depend, first of all, on monitoring the behavior of the signatories. An obscure agency of the European Commission, Eurostat, asserted responsibility for measuring whether country deficits and debts met the Maastricht Treaty's reference values. The story told about this agency's actions should be familiar, in general outline, to *PAR* readers: The agency developed capacity through entrepreneurial leadership and the expansion of technical expertise. It built on disciplinary foundations and the impressive capacities of the national statistical institutes of most EU countries (Greece and Portugal excepted). It simultaneously trusted countries for basic data, having decided to focus on the big problems, and relied on a fire-alarm system to catch problems, with assistance from the press. It made political mistakes and recovered but then was hurt by a financial scandal involving its leadership (not uncommon for the EU but somewhat disconcerting for this agency). In sum, Europe has developed a supranational authority—part agent and part trustee—to make definitive budget accounting judgments.

Helping to institutionalize Eurostat's function was the ubiquitous Europeanization project of harmonizing supposedly technical differences between countries. Consider the reference values for deficits and debts, which were apparently chosen because the French had already picked those targets in 1992 under President François Mitterrand, whose finance minister was Jacques Delors, who later authored the report that led to the Maastricht Treaty. In defense of these targets, they are consistent with the levels necessary to avoid exploding debt dynamics (given the typical growth rates of developed economies), and they certainly make more sense than, say, the targets set under the Gramm-Rudman-Hollings Act. But as the *Economist* wrote in 2003, it became clear that the targets would have little practical impact, that "the EU's fiscal rules will be be simultaneously unenforceable and unchangeable" because few leaders wanted to admit that the Europeanization fiscal convergence program was not progressing as planned.

Similarly, the basis for determining compliance was national accounts, not budget accounts—again, a very important decision made with little discussion or opposition from ministries of finance. It is inconceivable that the OMB would cede such responsibility to the Bureau of Economic Analysis without a knock-down fight. Savage reports that the decision to go with national accounts was partly the result of concerns that an alternative monitoring body, the European Court of Auditors, might be too tough on countries. Yet national accounts were also favored because of obvious problems with the typical cash basis of budget accounting and the ability of the national finance ministries to play games with these accounts. Consequently, an agency that was designed to keep track of the parts and whole of nations for the purpose of measuring economic growth was also asked to specialize in, say, whether a pension transaction between the government and a quasi-public organization should affect the deficit and debt.

This example refers to a specific case—the privatization of France Telecom—in which Eurostat (led by a French Eurocrat), as it implicitly admitted later, made a mistake by bending to French interests. In numerous other cases that Savage details, however, Eurostat acted as a technically oriented defender of rule-based accounting. These cases—involving gold sales, pensions, securitization, public–private partnerships, and so on—will be eerily familiar to anyone who has dealt with budget accounting controversies in the United States, and they imply that there are plenty of loopholes across the pond.

A particularly amusing case—for those with cynical tastes—is Italy's "eurotax." In 1997, Italy proposed a tax on prior-year income that would be imposed during the year in which Italy's deficit would be measured by the EMU membership, and then refunded the following year. Because the refund was not promised in law, Eurostat and a partner authority allowed Italy to count these revenues. However, had the refund been legislatively specified, it would have counted as a financial transaction, which under the EU's rules would not have affected the deficit. (Note that the U.S. budget baseline now counts future revenues from the scheduled expiration of past tax cuts that Republicans have promised politically to extend.) This example, and many others in the book, suggest that national accounts are not a complete solution to the problem of budget gimmickry (see Von Hagen and Wolff 2004). Here, Savage might have written more to compare the institutions, concepts, and mechanics of national and budget accounting.

While the excessive deficit procedure appears to have met its demise, long-run budget projections for many Europeans countries show fiscally unsustainable paths. Projections for the United States are similarly gloomy. No one in the United States is considering relying on a supranational authority to set budget constraints (though some worry there may come a day when the International Monetary Fund would play this role). Instead, some advocate applying accrual measures to the U.S. budget to reduce the practice of pushing costs onto future generations. If this can't be done head on, it would be interesting to consider whether emulating Europe's use of national accounts would partially substitute. Europe, in turn, could consider emulating the United States by increasing the political independence of budget accounting authorities at the national level. (For U.S. analyses comparing different accounting systems, see CBO 2004, 2006; OMB 2006; for a proposal regarding independent budget forecasts, see Jonung and Larch 2004.)

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