UNIVERSITY OF COPENHAGEN
FACULTY OF SOCIAL SCIENCES

The Politics of the Public Purse: Causes and Consequences of Fiscal Institutions

PhD Dissertation 2018

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Causes and Consequences of Fiscal Institutions

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Ph.D. dissertation submitted 25th of January 2018
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ISBN 978-87-7209-107-5 (Printed book)
ISBN 978-87-7209-141-9 (E-book)
Printed by SL grafik, Frederiksberg, Denmark (slgrafik.dk)

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3. Fiscal Transparency, Elections and Public Employment: Evidence from the OECD

4. Signaling to Creditors and Voters: The Determinants of the Strengthening of National Fiscal Rules

5. Fiscal Rules and Electoral Turnout

6. Do Fiscal Rules Reduce Political Polarization?

7. Budget Institutions and Taxation

Acknowledgements

This dissertation would not have been possible to do without the help and assistance of numerous individuals, whom I would like to give my thanks and show my appreciation for all your time and effort.

First, I would like to thank my advisor Peter Kurrild-Klitgaard, whose guidance, advice and critical yet constructive comments on draft after draft of the different papers of the dissertation helped improve them enormously and shaped the dissertation into something at least somewhat readable. Peter's advice and guidance both with regards to the process of writing the dissertation and the content itself made the almost three year journey both enjoyable and productive.

Special thanks also goes to David Dreyer Lassen, who has throughout the entire process provided valuable guidance on the subject matter and was so kind as to read part of the dissertation's content. Being a busy economist, I really appreciate the time and effort David has put into helping a young Ph.D. student from a completely different department. I have also benefitted enormously from comments and suggestions from Elin Naurin, Johannes Lindvall, Conor Little, Carsten Jensen, Asmus Leth Olsen, Mark Hallerberg, Joachim Wehner, Christopher Gandrud and many others including seminar and conference participants in Copenhagen, Berlin, Chicago, Philadelphia, London and Milan. The Center for Voting and Parties at the University of Copenhagen as well as my various research and seminar groups at the Department of Political Science at the University of Copenhagen have provided me with ample opportunity to present and receive feedback on parts of my dissertation. For putting and holding these groups together, I would like to thank Kasper Møller Hansen, Karina Korsiara-Pedersen, Peter Thisted Dinesen, Daniel Bochsler and Frederik Georg Hjorth. I would also like to thank the director of the Ph.D. program of the Department of Political Science Christian Rostbøll, who was always available to provide guidance on the Ph.D. program itself and made sure I had the necessary funding both for conference attendance and paper proofreading, which all improved the quality of my research markedly. Jon Jay Neufeld provided fast and efficient proofreading for the article, "*Budgetary Institutions and Taxation*."

During my research stays at Hertie School of Governance and London School of Economics, Mark Hallerberg and Joachim Wehner were so kind as to host me in Berlin and London respectively. I will always be grateful for the time and effort, they put into making my stay there joyful and productive, and I will do my best to visit as often as possible.

The research of the dissertation would not have been possible to conduct without the generous sharing of data and replication code from other scholars. I would like to thank Mark Hallerberg, Veronica Grembi and Nicola Mastrorocco for sharing their data with me.

Good friends and Ph.D. colleagues have also provided valuable help and assistance with my research during the three years, both with regards to technical assistance and methods discussions, reading suggestions, read-throughs and generally enjoyable and fun company. They include Mathias Heinze Pedersen, Benjamin C. K. Egerod, Bertel Teilfeldt Hansen, Jens Olav Dahlgaard, Jonas Hedegaard Hansen, Martin Vinæs Larsen, Søren Kjær Foged, Wiebke Marie Junk, Anne Mette Møller, Jacob Nyrup and many others.

Finally, much of the inspiration for this dissertation came while teaching a course on fiscal institutions and fiscal policy in a comparative perspective at the University of Copenhagen, first as an external lecturer and then as a Ph.D. student. I hope my students learned something during the course. I certainly did and I am still learning. For enabling me to do this, I will always owe them my gratitude, and I dedicate this dissertation to them.

1. Introduction

Fiscal policy and its components such as public expenditure policy, taxation policy and government debt issuing are the foundation of the functioning of the modern state and usually the very nexus of national politics.[1] In all countries; governments, parliaments and bureaucratic agencies each year need decide on how much to spend in each spending area, how to prioritize between public current spending and public investment, which taxes to raise and lower and whether and how to issue public debt.

However, as in most cases of public policymaking, these actors do not make these fiscal policy choices in an institutions-free environment. Formal and informal institutions, such as which actors have agenda setting power over the initial budget proposal, rules for amending the budget proposal, how much information there needs to be in the public budget and the existence of formal constraints for fiscal policy aggregates such as public debt and public expenditure and the public budget balance, all structure the political and administrative process of making fiscal policy decisions and thereby also the outcomes of these processes. These type of formal and informal institutions concerning government fiscal policy are referred to as fiscal institutions. There is significant institutional differences with regards to these fiscal institutions both between countries and within countries over time. In the United Kingdom, parliament has limited amendment power over the government's budget proposal and can only increase expenditures in one area by cutting them in another, while parliament face no such restrictions in the Netherlands (Wehner 2006; Hallerberg et al. 2009, 64). The German constitution has since 1969 provided explicit guidelines for the public budget balance, whereas the Icelandic constitutions contains no such measures (Lledó et al. 2017). Citizens and the media in the United States have access to detailed and comprehensive information about the public budget and official reliable public audits, while citizens in Venezuela gain very little information from reading the official public budget and in 2015 had access to no reliable public audits (International Budget Partnership 2015). While few rules and regulations governed the Swedish parliament's budgetary decisions before 1990, Swedish legislators have become increasingly subject to statuary and procedural limitations on their budgetary decisions since the middle of the 1990s (Hallerberg et al. 2009, 64; Lledó et al. 2017, 72).

While these differences might invoke normative judgements including their relationship to democratic ideals, the key question from a positive social science perspective is whether these institu-

1 Lasswell's (1936) classical description about politics as "Who Gets What, When, How" seems especially fit to describe the politics of fiscal policy.

tional differences actually matter for meaningful social, economic and political outcomes, and where these fiscal institutional differences come from in the first place. This dissertation deals with exactly these issues and seeks to answer what the political-economic causes and consequences of fiscal institutions are in a comparative perspective. It will concern key public policy outcomes such as public spending, taxation and the level of public employment as well as core features of a country's political life such as electoral turnout, political polarization and incumbent government power retention.

1.2 Definition and types of fiscal institutions

In this dissertation, fiscal institutions are defined as rules, regulations and procedures which govern the drafting, approval and implementation of the public budget (Alesina and Perotti 1996, 401). Using the distinction by Alesina and Perotti (1996, 401-404) the dissertation concerns three types of fiscal institutions.

The first type are numerical fiscal rules, which are rules of varying legal status[2] which set some sort of numerical limit either quantitative or qualitative on government fiscal policy aggregates such as expenditure, debt and the fiscal balance. Examples include constitutional clauses which states that the public budget should be in balance, rules which set formal ceilings for public expenditure growth and laws and procedures which set limits for the issuing of additional public debt.

The second type of fiscal institution are budget procedures, which are formal and informal rules and regulations which determine how the public budget is prepared, which actors have agenda setting power over the initial budget proposal, which actors can amend the initial budget proposal and how and whether the budget is prepared for one or several fiscal years to take just some examples.

The third type deals with the openness or transparency of the public budget, which concerns the extent to which the information in the public budget is widely available, the detail to which public expenditures and public revenue is broken down in the budget, whether there exists one or several yearly budget documents, whether the budget and/or supplementary fiscal documents contain reliable forecasts for key fiscal policy aggregates such as government debt and whether there is reliable and publically available public accounting. Regarding the content of the dissertation, three of the

2 Some fiscal rules are part of a country's constitution, others are put down in regular laws, while some are merely more or less formalized agreements among government coalition partners about future government fiscal policy.

dissertation's articles are on fiscal transparency, one deals with budget procedures while three of the articles concern fiscal rules.

A potential fourth type of fiscal institutions are independent fiscal councils, which provide evaluation of the public fiscal policy and sometimes provide technical assistance and fiscal and economic forecasts to be used in the drafting of the public budget, see Calmfors and Wren-Lewis (2011) for a wider discussion about fiscal councils. In this dissertation, fiscal council are not independently dealt with as a fiscal institutions, although the role of fiscal councils are included in some measures of fiscal transparency and fiscal rules strength which are used throughout the dissertation.

There exists considerable overlap and complementarity between the types of fiscal institutions. The existence of numerical fiscal rules might for an example shape public budget procedures and the existence of multi-year budgets also raises issues of the transparency of the public budget (Alesina and Perotti 1996, 403). New research also suggest that fiscal rules might have unintended consequences if fiscal transparency is low (Alt et al. 2014). However, in this dissertation each type of fiscal institutions is generally analyzed independently of the other fiscal institutions.

In all of the dissertation's articles, the focus is on national fiscal institutions. Supranational fiscal institutions also exist, often in the form of supranational fiscal rules which are often part of international currency unions. The most famous of which are the European Economic and Monetary Union's Stability and Growth Pact, amended in 2012 as the Fiscal Compact, which includes several numerical fiscal rules on public deficits and debt levels. This dissertation does not analyze the potential effects of these supranational fiscal institutions[3] but keep the focus on national fiscal institutions. However, some of the dissertation's articles do deal with potential international sources of national fiscal institutional change, including the potential influence of international organizations such as the European Union and the International Monetary Fund, which often promote fiscal institutional reforms.

The national and macro-comparative focus also means that issues of subnational fiscal institutions, which govern the fiscal policy decisions of subnational political unit such as states in federal systems, provinces and municipalities, play a minor role in this dissertation, see Foremny (2014) and Burret and Feld (2017) for recent studies on the effect of subnational fiscal rules. Subnational fiscal institutions are however not entirely ignored. When quantifying the strength of national fiscal rules in the three articles which deal with this subject, it is taken into account whether the fiscal rules also

3 See Koehler and König (2015) and Hallerberg and Baerg (2016) for recent political science research on the Stability and Growth Pact.

apply to subnational government. Furthermore, in one of the dissertation's articles, the impact of changes to a subnational fiscal institutional framework in Italy is used to causally identify the effect of fiscal rules on electoral turnout.

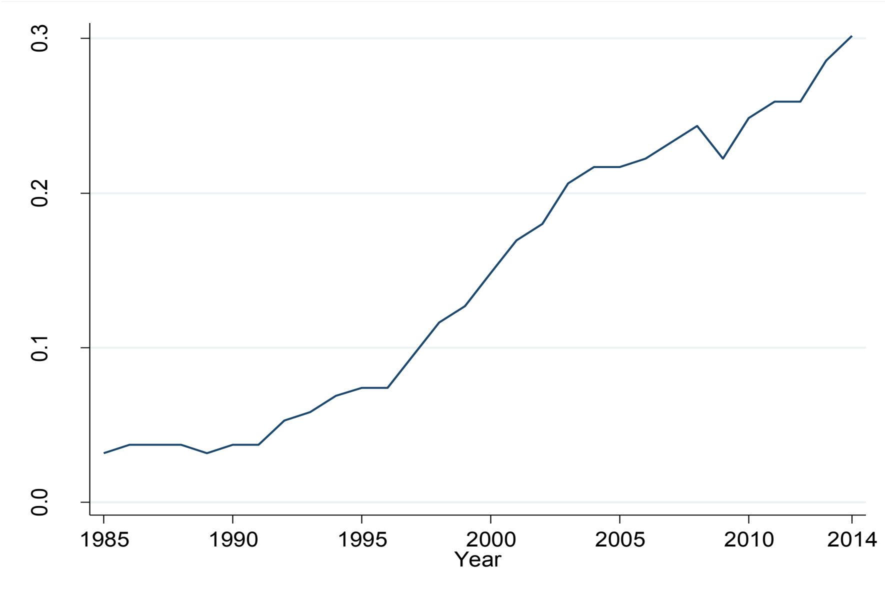
1.3 Background: The growing importance of fiscal institutions

Over the past decades there has been a growing interest among policy-makers and policy analysts in fiscal institutions and their effects. Given periodical issues with government debt and deficit crises in both developing and developed countries, fiscal institutional reforms in the form of more stringent budget procedures, greater transparency of the public budget and enactment of numerical fiscal rules have been heralded as a potential solution to excessive government debt accumulation and large fiscal deficits. International organizations such as the Organization for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF) and the European Union (EU) as well as non-government organizations increasingly advocate reforms to countries' fiscal institutional framework and push for more rule-based, more stringent budget procedures and greater transparency of the public budget.[4] National politicians and civil servants have often also been increasingly interested in adjusting national fiscal frameworks.

Consequently, this growing interest has materialized in several fiscal institutional reforms across countries both in the developed and developing world over the past decades. Especially within the area of national numerical fiscal rules, the has been a growing trend towards more and more countries implementing one or more national fiscal rules as evident from figure 1, which is taken from one of the dissertation's articles. A 2009 study of 15 European Union countries also found that these countries have generally moved to more stringent and hierarchical budget procedures from the early 1990s to the early 2000s (Hallerberg et al. 2009, 53-75). The often substantial changes to national fiscal institutions, which has happened in recent years, further increases the relevance of the question of whether these institutions have had any significant impact on national policies and the conduct of national politics. These trends also raise the question of which factors have driven these institutional changes.

4 This is especially reflected in the enormous amount of publications on fiscal institutions and fiscal institutional reforms published by these organizations over the past decades. See for an example Cangiano et al. (2013) for a very comprehensive account of fiscal institutional reforms.

Figure 1. Share of countries with at least one national fiscal rule in place 1985-2014



Source: The IMF's Fiscal Rules Database.

1.4 The dissertation's content

The dissertation itself[5] consists of seven self-contained papers, which all deal with different aspects of the three main types of fiscal institutions, fiscal transparency, fiscal rules and budgetary procedures. The papers are:

1. Aaskoven, Lasse. "Oil Windfalls, Elections and Fiscal Transparency."

> This article argues that oil windfalls increase election year public spending but that fiscal transparency mitigates this effect. Oil-induced electoral budget cycles decreases as fiscal transparency increases. Using a high quality measure of fiscal transparency in a panel of countries, robust evidence in favor of this argument is found.

5 Regarding inspiration for the structure of the dissertation's introduction as well as the general outline of a paper-based dissertation, I owe a great deal to the excellent dissertations of Hariri (2012) and Hansen (2014).

2. Aaskoven, Lasse. “Fiscal Transparency and the Electoral Consequences of Fiscal Policy.”

> This article tests whether the ability of voters to observe fiscal policy through increased levels of fiscal transparency affects government reelection chances. Using data from elections in 21 OECD countries from 1982 to 2012, the results show that fiscal transparency does seem to mitigate the effect of government fiscal policy on government reelection chances. Under high levels of fiscal transparency government reelection chances are not hurt by electoral term expenditure cuts and the chance of government turnover might even increase in the case of fiscal expansion. Fiscal transparency also seems to affect the electoral consequences of electoral term increases in public revenues.

3. Aaskoven, Lasse. 2016. “Fiscal Transparency, Elections and Public Employment: Evidence from the OECD.” Published in *Economics & Politics* 28 (3).

> This article highlights the importance of fiscal transparency in determining changes in public employment. It argues that economic growth increases public employment under low fiscal transparency and that this effect is strongest in years of election. These hypotheses are tested on a panel of 20 OECD countries from 1995 to 2010. The analyses show substantial evidence in favor of the arguments. Fiscal transparency lowers the positive effect of growth on public employment, a relationship, which is most robust in election years.

4. Aaskoven, Lasse. ”Signaling to Creditors and Voters: The Determinants of the Strengthening of National Fiscal Rules.”

> This article theorizes and investigates the causes of differences in the stringency of national fiscal rules and their auxiliary institutions. Building on an argument that incumbent government use the strengthening of the national fiscal framework as a signal of fiscal prudence to both creditors and domestic voters, the article finds evidence that national fiscal rules framework are strengthened before national elections and when government debt is high.

5. Aaskoven, Lasse. “Fiscal Rules and Electoral Turnout.”

> This article investigates whether numerical fiscal rules lowers electoral turnout and increases turnout inequality between the rich and the poor. Using both aggregate turnout data for a large number of democracies as well as European individual-level data and causal identification in Italian municipalities, this articles finds little robust evidence that fiscal rules decrease turnout and increase turnout inequality.

6. Aaskoven, Lasse. "Do Fiscal Rules Reduce Political Polarization?"

> This article explores one potential aspect of numerical fiscal rules' effect on a country's political life, namely its effect on the level of political polarization. Using party manifestos data from 185 elections in 32 OECD countries, this article finds little robust evidence that fiscal rules independently reduce the level of political polarization.

7. Aaskoven, Lasse. "Budget Institutions and Taxation."

> This article argues that increased centralization of the budget process increases taxation by limiting individual government members' ability to veto tax increases in line with the common-pool problems arguments about public finances. Using detailed data on budgetary procedures from 15 EU countries, the empirical analysis shows that increased centralization of the budget process increase taxation as a share of GDP and that both type of budget centralization and the level of government fractionalization matter for the size of this effect.

1.5 Relationship to previous literature

The dissertation's papers builds on an extensive and well-established research agenda on fiscal institutions in both economics and political science. Alongside and sometimes preceding the policy interest in fiscal institutions, scholars within public economics and increasingly also political science and public administration have researched and discussed the effects of different types of fiscal policy institutions on fiscal policy outcomes. The early literature often focused on fiscal rules and budget procedures in US states (von Hagen 1991; Poterba 1994; Alt and Lowry 1994) often with references to the European Union's fiscal rules framework (Inman 1996). A research tradition recently revitalized in the aftermath of the Eurozone fiscal crisis (Kelemen and Teo 2014). Alesina and Perotti (1996) provides a review of the earlier empirical evidence of the effects of fiscal institutions.

Regarding more recent research which summarizes much of the previous literature on the effects of fiscal institutions, Heinemann et al. (2017) present a new so-called meta-regression study for the effects of fiscal rules, where the results from 30 studies of the fiscal policy effects of fiscal rules are analyzed. The conclusion from this article generally seems to suggest that fiscal rules might decrease government deficits. De Renzio and Wehner (2017) provides a review of the fiscal policy effects of fiscal transparency, where the evidence suggest that increased fiscal transparency decreases government debt accumulation and increases sovereign credit ratings. For budget procedures, studies of both Latin American countries (Alesina et al. 1999) and the European Union (Hal-