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Article

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Budgetary Research Review (BRR)

Provided in Cooperation with:

Budgetary Research Review (BRR)

Suggested Citation: Raudla, Ringa (2013) : Budgeting during austerity: Approaches, instruments and practices, Budgetary Research Review (BRR), ISSN 2067-1784, Budget Finante, s.I., Vol. 5, Iss. 1, pp. 30-39

This Version is available at:

<https://hdl.handle.net/10419/157650>

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Budgeting during Austerity: Approaches, Instruments and Practices

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Introduction

The recent global financial and economic crises, followed by fiscal crisis, have led many governments in Europe to adopt austerity measures in order to cope with the concurrent problems of lower revenues and high public debt. It can be expected that the need to undertake large-scale cutbacks would lead to changes in budgeting practices, budgetary institutions and modes of fiscal governance. Based on the existing literature on fiscal governance and budgeting, it can be conjectured that in response to fiscal stress, the following shifts have taken (or are taking) place in fiscal governance and budgetary institutions: movement from decentralized and bottom-up modes of budget preparation to centralized and top-down modes, adoption of numerical fiscal rules, and the revival of the “more rational” budgetary decision-making techniques (e.g., performance-based budgeting, results-based budgeting, etc.).

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1. Top-down budgeting

The existing literature on fiscal governance, budgetary institutions and cutback management shows that fiscal stress and the need to cut back budgets is likely to bring about a shift towards more centralized arrangements in fiscal governance, including the adoption of a more top-down approach to budgeting and increasing the power of the ministry of finance vis-à-vis the line ministries (and the minister of finance vis-à-vis the rest of the cabinet) (see, for example, Behn 1985; Molander 2001; Di Mascio, Natalini and Stolfi 2013; Hendrick 1989; Schick 1986).

Centralization of budgetary decision-making can even be seen as a necessary pre-condition for undertaking retrenchment because the organizational subunits would be very unlikely to volunteer the making of cuts (see, e.g., Behn 1985; Bozeman and Straussman 1982; Levine 1985; for a theoretical discussion about the collective action problems on the budgetary commons, see Raudla 2010b). The line agencies and ministries would be likely to believe that they have very “special characteristics” not suitable for cuts (Dunsire and Hood 1989, p. 131) and hence appeals for budget-cutting are likely to elicit a “you first, then me” type of responses from lower levels of organizations, implying that top-down decisions would be needed to go ahead with cuts (Levine 1979, p. 181). In other words, it would be difficult to achieve cutbacks via (traditional) bottom-up modes of budgeting since it is unlikely that the line agencies or subordinate agencies would volunteer making the cuts themselves. In order to achieve the making of cuts, the Ministry of Finance or Treasury (or an equivalent), would have to give the line ministries and agencies targets or spending ceilings before they start formulating their budget requests for the following fiscal year. The goal of such targets would be to constrain spending demands and to provide a focal point for subsequent budget negotiations. In other words, fiscal stress and the need to adopt austerity measures is likely to bring about a shift in the balance of power between the “guardians” (or “constrainers”) in the ministry of finance (or central budget offices) and the “claimers” in the line ministries or agencies during budget preparation and negotiations (see, e.g., Schick 1986).

Alongside more top-down decision-making on the budgetary aggregates, the cutback budgeting is likely to bring about more flexibility at the lower levels, meaning that it would be the lower-level civil servants

who have to decide on where exactly the budget cuts would fall. (Re)creating budgetary flexibility at lower levels of decision-making would be necessary for several reasons. Schick (1988, p. 531), for example, notes that the retrenchment process, which is accompanied by tighter controls and less discretion, may demoralize public servants and hence “more managerial flexibility can be an implicit quid pro quo for giving agencies less money.” Also, he argues that allowing agencies and line ministries to reallocate the reduced funds according to their perceived needs would be a way for easing the resistance to cuts (p. 531).

A number of empirical studies appear to confirm the necessity of (re)creating budgetary decision-making flexibilities at lower levels. For example, Schick (1988) points out that in response to fiscal stress and the need to undertake cutbacks in 1980s, a number of countries relaxed detailed expenditure control and provided funds for broader categories in the budget (e.g. Sweden, Canada, Australia, UK, Ireland, Denmark). This often took the form of block appropriations and greater flexibility given to the agencies for making reallocations within the block appropriations.

The empirical studies looking at the Baltic countries in 2008-2012 find similar patterns of fiscal stress leading to tighter top-down controls on aggregates combined with higher flexibility on lower levels. Fiscal stress in those countries led to significant shifts toward centralizing the budget process: the powers of the ministers of finance vis-à-vis the line ministers increased, especially when it came to imposing expenditure ceilings (or targets for expenditure cuts). As Raudla (2013) argues, during the boom years (2004-2007), the powers of the minister of finance (and the Finance Ministry as a whole) had somewhat weakened in Estonia: as a result of windfall revenues and repeated adoption of positive supplementary budgets, patterns of bottom-up budgeting had emerged and the “ceilings” imposed at the beginning of budgetary negotiations came to be viewed as negotiable by the line ministries (see also Raudla 2010a). Once the crisis set in, however, the top-down budgeting foreseen in the organic budget law was reinstated, with the minister (and ministry) of finance assuming strong control over the expenditure ceilings and cutback targets. Though clear shifts towards centralizing budgetary decision-making could be observed in all three countries, then when it came to decisions how the cuts to operating expenditures were to be achieved, these decisions were delegated to lower levels (e.g., to line ministers, department heads and

program managers) who had to decide on the specific content of cutbacks (Raudla 2013).

2. Performance budgeting

Besides top-down budgeting, the fiscal crisis is likely to revive calls for more “rational” forms of budgeting like performance-based budgeting, results-based budgeting, program budgeting etc. During the period of austerity in the 1980s, Schick (1988) observed, for example, that “Cutback pressures have inspired efforts to import the techniques and ethos of business management into the public sector. The view is now widespread that, to obtain value for money, governments must hold spenders accountable for the costs they incur and results they produce.” Dunsire and Hood (1989) also conjectured that the fiscal crisis is likely to bring along an increase in monitoring and evaluation of organization’s activities, and renewed emphasis on management efficiencies to discover “the waste” (Dunsire and Hood 1989). As Pollitt (2010, p. 18) notes, though, the implications of austerity for such reforms can be ambiguous. On the one hand, scarcity may make the implementation of such reforms more difficult as they cannot be “lubricated with new money”; on the other hand, a sense of urgency may render it more attractive to consider more fundamental changes in order to “rationalize” the budget-allocation process (p. 18). Schick (1988, p. 532) has argued that in the midst of the crisis, undertaking extensive reforms of budget process is not very likely because budgeting becomes more focused on the short term than on the long term. He argues that during the crisis, budgeting tries to go “back to the basics” and focus on expenditure control. Because of the “fixation on short-term gapmanship” during acute fiscal scarcity, the planning aspect of budgeting is likely to become less important; however, there might be some increase in “evaluative activities” and renewed focus on “management efficiencies” (Schick 1980, p. 127).

Schick (1988, p. 528) observes that in response to fiscal stress in the 1980s, some industrialized countries did increase their use of evaluation methods to “weed out unproductive or low-priority programs” (see also Dunsire and Hood 1989), but in most countries fiscal stress did not spark “widespread interest in cost-effectiveness studies and similar

techniques associated with planning-programming-budgeting (PBB) during the growth era.” All in all, Schick concludes that the adjustments in budget processes have tended to be “piecemeal, ad hoc, and improvisational” and that “in most countries, the adjustments have not uprooted the core processes established over decades of budgetary development” (p. 532).

In the three Baltic countries, for example, one can observe two tendencies with regard to performance-based budgeting during the crisis. On the one hand, the recent crisis has indeed reinvigorated the plans of the ministries of finance in those countries to rationalize the budget processes and put the reform of performance-budgeting (and also creating stronger links between strategic plans and budgets) on the governments’ agenda (see, for example, Raudla 2012b). On the other hand, when actually making the cuts in 2009-2011, the consolidation efforts were more driven by the goal to control aggregate expenditures than making decisions on the basis of performance information (see, for example, Raudla 2012a). In the midst of the crisis, the budgeting went “back to the basics”, to use the terminology of Schick (2009).

3. Fiscal rules

The fiscal imbalances in Europe have led to calls for establishing stricter fiscal rules, both on the supranational and national level. Kopits and Symansky (1998) emphasise that if fiscal rules were to be effective, they should be well-defined (with regard to the indicator to be constrained, the institutional coverage and specific escape clauses), transparent, simple, flexible (to accommodate exogenous shocks), adequate (with respect to the specified goal), enforceable, consistent (both internally and with other policies) and efficient. They point out, though, that no fiscal rule can fully combine all these features. Hence, there are usually significant trade-offs that have to be made in establishing fiscal rules, which may underline their overall effectiveness.

Probably the most important tradeoff that has to be made in designing fiscal rules is between simplicity and flexibility. In order to strike an optimal balance between these two features, one has to keep in mind how the fiscal rule is foreseen to be enforced. In other words, if we think that a fiscal rule is necessary, then what the best rule would be depends

very much on what we consider to be main enforcement mechanism for the rule. If we assume that the main reason politicians stick to the fiscal rule is that they are afraid of the electoral backlash when they deviate from the rule, then simplicity and transparency of the rule is a precondition for it to work. The main problem with such very simple rules (like was the case with the Maastricht deficit criterion of 3% of GDP) is that they may prevent macroeconomic stabilization via automatic stabilizers and fiscal stimulus. Hence, such a simple and transparent budget balance rule may needlessly prolong an economic downturn and this in turn could prove self-defeating in the long run. Conversely, during good times, such a simple headline balance rule may encourage cyclically loose fiscal policies because it may not give sufficient guidance about how large surpluses the government should run.

One possible solution to alleviate such pro-cyclicality is to make the rule more “flexible” and to require the fiscal policy to adhere to a cyclically adjusted balance or a structural balance and to allow possible deviations in the case of severe economic recessions and other emergencies. However, in the case of such more sophisticated rules (as outlined in the Fiscal Compact, for example) the general public may not be able to evaluate whether the government has complied with the fiscal or not. Indeed, even economists may not be able to say with full confidence what the structural balance actually is at any point in time because of the difficulties and uncertainties involved in calculating the potential output and the revenue and expenditure elasticities. Indeed, the ex ante, real time and ex post assessments of the structural and cyclically adjusted balances may diverge significantly.

In other words, in the case of such more “sophisticated” fiscal rules, relying on the electorate as the main enforcement mechanism is not feasible anymore. Alternative mechanisms entail enforcement by the constitutional courts, financial markets and independent fiscal councils. All these enforcement mechanisms, however, have their own shortcomings. First, the (constitutional) courts may not have either the willingness or the competence to evaluate the structural or cyclical balances and intervene in fiscal policy-making (for a theoretical discussion on the role of courts in fiscal policy, see Raudla 2011). Furthermore, even if the constitutional courts are willing to pass decisions on the violations from the fiscal rule, the legislature may simply choose to ignore those judgments (Raudla

2010c, 2011). Second, the experience with financial markets as enforcers of fiscal discipline is not too promising either: they can often be either too “slow” or too “neurotic” or both, first too slow to react and then overreact. In other words, the financial markets do penalize fiscal profligacy but they do it in a rather discontinuous fashion and only with significant time lags and often only at extreme stage (Balassone et al., 2004; Debrun et al. 2009). Finally, the use of independent fiscal councils as an institutional device for helping to enforce fiscal rules (see Wyplosz 2005; Debrun and Kumar 2008; Debrun et al. 2009) appears to be the most attractive option, at least theoretically. How well the fiscal council can act as an enforcer of fiscal rules depends, of course, on what exactly their mandate is, what resources they have for conducting independent analysis etc. Besides monitoring the government’s compliance with the fiscal rule, the Fiscal Council could also contribute to economic policy discussions in the public sphere and raise the level of public debate on macro-economic issues. If well-designed, the Council can serve as an “interface” between the general public and the government.

In the end, however, the main lesson from the literature fiscal rules (see Raudla 2010c for an overview) is that the effectiveness of fiscal rules depends on political leaders: the rules will work if politicians want them to work and will not work if the political commitment is lacking. If politicians don’t want to comply with the fiscal rules, they will usually find a way to evade them, either explicitly or implicitly by engaging in creative accounting and off-budget operations. As Schick (2003) has noted, in countries where fiscal rules are most needed, they may be least workable and where conditions are most hospitable to fiscal constraints, they may be the least needed (see also Anderson and Minarik 2006; Kennedy and Robbins 2001; Kopits 2004).

Thus, in the light of the previous experiences with fiscal rules, it is rather difficult to be optimistic about the impact of the Fiscal Compact. Given that the implementation (and the enforcement) of the structural budget balance rule is left to the member states, the effect of the Fiscal Compact will clearly depend on the political will of the decision-makers in government of the member states.

Concluding remarks

In sum, the need to deal with the fiscal crisis and the adoption of austerity measures is likely to bring about significant shifts in budgetary processes and practices. In those countries where bottom-up budget processes dominated in the run-up to the crisis, the pressure to adopt more top-down approach to preparing the budget is likely to emerge. In those polities where top-down processes already prevailed, these practices are likely to be strengthened. With regard to the resurgence of performance-based budgeting, then based on the experiences with the previous periods of austerity and some preliminary evidence from the current period, it can be argued that the use of performance measures is likely to be reduced in the midst of the crisis, while it can be predicted that after the peak of the crisis is over, the reform rhetoric pointing to the need to “rationalize” budgetary decision-making (e.g. with the help of performance measures) is likely to return (probably with vengeance). Finally, the fiscal crisis has already brought about a proliferation of different fiscal rules, both on the supra-national and national level. To what extent the new fiscal rules will have a different effect from those in the past depends on the political will and commitment of the politicians in charge of the decisions on fiscal policies. The question of whether the EU and the member states should pursue austerity measures in the midst of economic recession is an altogether different question and would need to be discussed in a separate paper.

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