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

Overseas Development Institute, May 20th 2008

* Based on joint work with Ernesto Stein. Project financed by IDB and DFID. The views and interpretations in this document are those of the authors and should not be attributed to the Inter-American Development Bank, or to any individual acting on its behalf.
Overview of the Presentation

- The budget process and the traditional literature
- Need for a new approach
  - Budget process is an intrinsic part of the policymaking process
  - Understand incentives of the actors in a general equilibrium approach
  - Actual practices are as important as formal rules
  - Fiscal outcomes such as efficiency and representativeness are as relevant as sustainability
- Our framework and project
- Forthcoming book
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 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 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
For example, some of the studies on political institutions have looked at the impact of:

- 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.
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)
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.
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 **Europe**: Von Hagen (1992) and von Hagen and Harden (1995), Hallerberg and others (2001)
Explaining Fiscal Outcomes. Budget Institutions

Index of budget institutions

Source: Scartascini and Filc (2005)
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.
### Table 5.1 Summary of fiscal reforms in Latin America

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Argentina</strong></td>
<td></td>
<td>N, F</td>
<td>U, E</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Bolivia</strong></td>
<td></td>
<td></td>
<td>S</td>
<td>U</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Brazil</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Colombia</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Chile</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Costa Rica</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Ecuador</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>El Salvador</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Guatemala</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Honduras</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Mexico</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Nicaragua</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Panama</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Paraguay</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Perú</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Dominican Rep</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Uruguay</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Venezuela</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**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)
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 (1)

1. It’s essential to know the particular institutional context within which the players play the game, who the players are, and what the incentives are 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 (1)

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

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

Towards a New Framework (2)

2. To understand why some reforms work (or are adopted) in some countries, but not in others, it is important to understand that the budget process is part of the general **policymaking process**.

- 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.

- Others have passed budget reforms even though the fiscal fundamentals had not changed for gaining power in the political process (e.g., presidential “superpowers” in Argentina).
Note:
Horizontal axis: Budget institutions index
Vertical axis: Primary general government balance

Scartascini and Filc (2005)
Towards a New Framework (3)

3. It is not only important to understand the *formal rules* of engagement between the players but also the *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)

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)

-5,0%
-3,0%
-1,0%
1,0%
3,0%
5,0%
7,0%
9,0%

Russian Crisis
Beginning of Current Boom
Fiscal Revenues
Adjusted Revenues
Fiscal Expenditures

Russian Crisis
Beginning of Current Boom
Observed Balance
Rule
Structural Balance

Source: Talvi, Ernesto (2007), “If Latin America Were Chile: A Note on Structural Fiscal Balances”. 
Towards a New Framework (4)

4. When trying to evaluate the actual impact of fiscal rules and the soundness of fiscal accounts, it is important to move from the simple measures of fiscal performance (e.g., primary balance).

   □ For example, use measures of structural balance instead of current fiscal balance (of course, be aware of manipulation).
Measuring Fiscal Performance

- As we have shown in a previous slide, in Argentina it took several years (and reforms) to finally comply with the (several times revised) Fiscal Responsibility 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 Bimates and Public Debt

Fiscal Balance

(% of GDP)

Towards a New Framework (5)

5. In addition to looking at fiscal sustainability (which has been the traditional focus of the literature), new studies should take into account other interesting dimensions, such as efficiency and representativeness.

- Despite the fact that 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 (better than the performance of the economy).
- Most people think that the allocation of spending is wasteful and improvements have not been correlated to improvements in the fiscal balance.
Measuring Fiscal Performance

Government Efficiency Fighting Poverty and Composition of Government Expenditures

Data source: GCR (2005 and 2006)
Measuring Fiscal Performance

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

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
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.
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.
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

Score (standardized scale)

8,758 9,036 9,199 10,469 11,261 12,794

1998 1999 2000 2001 2002 2003 2004

Lenguaje & communication
Mathematics
Public expenditure on secondary education

Millions of nuevos soles of 2001
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: 

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

Where:
- \(Bi\): is the participation of item \(i\) in total spending presented in the Executive budget proposal.
- \(Li\): 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

Changes to the budget at each stage
(average 1997-2005)

Changes as % of the budget

<table>
<thead>
<tr>
<th>Country</th>
<th>Draft-Approved</th>
<th>Approved-Modified</th>
<th>Modified-Executed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colombia</td>
<td>0.00%</td>
<td>2.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Peru</td>
<td>4.00%</td>
<td>6.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Venezuela</td>
<td>6.00%</td>
<td>8.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td>Brazil</td>
<td>8.00%</td>
<td>10.00%</td>
<td>12.00%</td>
</tr>
<tr>
<td>Ecuador</td>
<td>10.00%</td>
<td>12.00%</td>
<td>14.00%</td>
</tr>
<tr>
<td>Bolivia</td>
<td>12.00%</td>
<td>14.00%</td>
<td>16.00%</td>
</tr>
</tbody>
</table>
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.

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

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 (their longer versions have already been published as IDB working papers) are ready.
- We hope to have it published before the end of the year.

…Thank you
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. The views and interpretations in this document are those of the authors and should not be attributed to the Inter-American Development Bank, or to any individual acting on its behalf.