Understanding Public Debt from a Political Economy Perspective

Nouha Bougharriou*

Summary
This paper surveys the recent political economy literature on fiscal policy with a focus on public debt. We provide theoretical discussions on the political and institutional factors shaping fiscal policy. The literature suggests that the opportunistic and ideological behavior of politicians, the conflicts of interest among political parties, and the distribution of debt burden across governments and generations may all lead to excessive public debt. However, many studies emphasize the role of budgetary institutions in promoting fiscal discipline. More specifically, adopting fiscal rules, improving fiscal transparency, centralizing the budget process, and creating an independent fiscal authority are considered as institutional solutions to address excessive deficits and debts.

Key words: Public debt, Fiscal policy, Political economy

JEL Classification: P16, E62, H61, D72

1. Introduction
The persistence of budget deficits and the accumulation of public debt in both developed and developing countries over the past decades have caught the attention of policy-makers and researchers. In fact, since the first oil crisis of 1973, many industrialized countries have incurred large budget deficits. The financial crisis of 2008 as well has led to a rapid increase in public debt levels in major advanced countries. These facts expose the need for a theoretical understanding of the factors affecting public debt. Analyzing public debt from a normative approach, economic literature holds the view that budget deficit occurs when government spending exceeds government revenue. According to the 'tax-smoothing' model, the optimal policy implies maintaining tax rates constant over time so that spending and revenue shocks are smoothed out by budget deficits and surpluses (Barro, 1979; Lucas and Stokey, 1983). However, by predicting that the deficit biases would disappear in times of economic boom, normative economic theory seems to be unable to explain both the persistence of deficit and debt in most countries, and the cross-country differences in public debt. Thus, the existing theory remains inadequate as it has ignored the role of political processes in shaping fiscal policy. Accordingly, providing a positive explanation that takes into account the political and institutional aspects of the issue is of key relevance.

Analyzing public debt from a political economy perspective, several arguments have been put forward. Interestingly, the literature on the topic suggests that budget deficits and the resulting public debts could be affected by politicians' behavior. Winning the next elections in order to enjoy the
advantages of being in power is the main concern of opportunist politicians who take advantage of the myopia of voters and use budget deficits before the elections to increase their chances of reelection. The ideology of the ruling political party can also affect debt levels. Generally, left-wing governments are supposed to run more deficits than right-wing ones. In addition, debt can be used to influence successor government policies, especially if present and future fiscal policy preferences are different. The conflicts of interests between political parties, on the one hand, and members of parliament, on the other, may in turn drive up public debt.

The political economy literature on fiscal policy also provides new insights into the effect of the institutional framework of fiscal policy on fiscal performance. In fact, well-designed budgetary institutions are associated with lower deficits and debt levels. In other words, the adoption of fiscal rules that impose some restrictions on expenditure, deficit and debt may improve fiscal performance. Besides, a transparent budget that provides citizens with accurate representation of spending, revenue and deficit forecasts fosters the accountability of decision-makers and accordingly improves fiscal discipline. Moreover, a centralized budget process that lends special authority to the minister of finance as well as the creation of an independent fiscal authority aimed to set the maximum level of the admissible debt may limit the government's ability to issue debt.

This paper offers a survey of the political economy models of public debt that have attempted to fill the gap of the economic literature. The paper is organized as follows. Sections 2, 3 and 4 provide a brief overview of the literature on the political determinants of public debt, which shows that the former is the result of opportunistic and ideological behavior of politicians, conflicts of interest among political parties and debt burden distribution across governments and generations. Section 5 highlights the institutional factors of public debt. It makes the assumption that adopting fiscal rules, improving fiscal transparency, centralizing the budget process and creating an independent fiscal authority may mitigate deficit bias and debt accumulation. Finally, section 6 winds up the discussion by drawing conclusions.

2. Politicians’ behavior: opportunism versus ideology

The tendency of democracies to generate excessive fiscal deficits and accumulate debt is associated with the electoral process and, more specifically, with the behavior of politicians during the election period. The theory of "political business cycle" predicted by Nordhaus (1975) claims that excessive budget deficits can be explained by the opportunistic behavior of politicians who are keen on retaining power. Based on the traditional Philips-curve approach, Nordhaus (1975) argues that prior to elections in order to increase their chances of being reelected, politicians tend to create inflation in an attempt to reduce unemployment by pursuing an expansionary fiscal policy. Politicians take advantage of voters' myopia who generally fail to realize that these pre-election expansionary policies will lead to a post-election economic recession. Indeed, voters often overstate the benefits of current expenditure, underestimate the current and future tax burdens and decide their preference in accordance with the short-term economic situation.

The impact of the pre-election debt manipulation on politicians' electoral success has been investigated by many researchers. Drazen and Eslava (2010) show that an increase in public investment spending before elections improves politicians' reelection chances in Colombia. Aidt et al.
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(2011) suggest that opportunistic behavior prevails in Portugal, especially when the likelihood of winning the next elections is low. Examining the impact of debt accumulation on the probability of politicians’ reelection in French municipalities, Cassette and Farvaque (2014) argue that voters are fiscally conservative and punish incumbents for debt accumulation only when debt is accumulated at the beginning of the mandate and not in the last two years prior to elections. In other words, although voters are conservative, they may be manipulated by a short-term increase in public spending.

While the aim of opportunistic politicians is to preserve power, partisans have purely ideological motivations. According to the theory of partisan cycles, Hibbs (1977) highlights that budget deficit is higher when left-wing parties are in office. In fact, left-wing and right-wing parties have different positions on economic issues. More specifically, given that left-wing governments are supported mainly by the working class that generally suffers from unemployment, they pursue expansionary policies that drive up public expenditure and deficits. However, right-wing voters are generally capital owners who attach greater importance to inflation. For this reason, right-wing governments undertake restrictive policies inducing lower spending and deficits.

The ideological orientation of the government does not only affect the budget size but also the composition of public spending. Potrafke (2011) argues that, in order to reveal their political views to voters belonging to all social groups, left-wing governments tend to spend more on public services and education than the right-wing ones. Furthermore, Herwartz and Theilen (2014) emphasize that the ideological behavior of politicians plays an important role in explaining the short-term dynamics of social spending. However, the ideological influence on social spending depends on the existing budget deficits.

3. The strategic use of debt: current government versus future government

Debt can be used by current policymakers as a strategic tool to influence the fiscal policy choices of future governments. Anticipating a possible defeat in the next election, the government may leave large deficits to its successor, especially if they have different preferences with regard to the allocation of spending. More specifically, if the current policy-makers favor defense spending and estimate that the future government has preferences for social spending, they can increase the deficit, accumulate more debt and thereby force its successors to reduce their social expenditure in order to service the debt (Alesina and Tabellini, 1990). This phenomenon prevails in case a right-wing government anticipates the election victory of the left-wing parties (Persson and Svensso, 1989).

4. Intergenerational redistributions: current generation versus future generation

Intergenerational redistribution may also generate the accumulation of excessive public debt. Interestingly, public debt can be redistributed through shifting tax burdens across generations. Indeed, it is worth noting that the current generation takes advantage of future generations as the individuals can exercise their voting right and choose the incumbent whose policy preferences coincide with their own. According to the “Ricardian equivalence theorem” (Barro, 1974), a selfish generation would vote for policies that shift the tax burden to future generations. However, a rational and altruistic generation that anticipates an increase in public debt would raise savings and maintain its consumption levels to protect future generation from tax increases.
Cukierman and Meltzer (1989) propose a particular model of intergenerational redistribution. The model predicts that rich and poor parents have different attitudes toward debt accumulation. In fact, rich parents are indifferent to the debt policy since they can adjust their wealth to any change in current taxes and deficits. However, poor parents encourage public debt and thus indirectly borrow from future generations. As society is mainly made up of poor people, debt is certainly going to accumulate.

5. Distributional conflicts and war of attrition: coalition governments versus majority governments

The disagreements and strategic conflicts among policy-makers who have an influence on budget decisions can lead to higher budget deficits. These political conflicts are more evident in countries with coalition governments rather than those with majority ones. In fact, it is much more difficult for the different parties that form the coalition to reach a consensus. More specifically, in a coalition government, each party defends the interests of the constituency or social groups (workers, farmers, firms or ethnic and religious groups) that it represents and will only offer budget cuts which have no negative effect on its own constituency (Roubini and Sachs, 1989).

Moreover, in comparison with majority single-party governments, coalition governments are willing to stay in office for a shorter time period, which makes the probability of cooperation between political parties relatively low. Ultimately, it is hard to control public debt in countries with unstable governments (De Haan and Sturm, 1994).

Alesina and Drazen (1991) propose the "war of attrition" model, according to which a conflict can occur between policymakers regarding the distribution of tax burden. These conflicts are most often associated with budget adjustments needed to overcome exogenous and permanent fiscal shocks. Accordingly, the longer the time taken to reach agreement, the higher the debt accumulation and the greater the tax distortions.

6. Budgetary institutions

A large and growing literature dealing with the possible determinants of public deficits emphasizes the role of institutional factors in shaping fiscal outcomes (Eslava, 2011). Defined as the set of rules, procedures and practices according to which public budgets are drafted, approved and implemented, the institutions governing the budget process have played a critical role in containing budget deficits and reducing public debts (Alesina and Perotti, 1999; Gleich, 2003; Gollwitzer, 2011; Giuberti, 2015). Accordingly, well-designed budgetary institutions are associated with improved fiscal performance.

In a democracy, voters give power to politicians to make policy and spending decisions. The delegation of power to elected politicians may create two major problems that can lead to excessive levels of spending, deficits and debt: the principal-agent and the common pool problems. Driven by their desire to win elections and to take advantage of being in power, instead of acting in the best interest of the electorate, elected politicians may use power to extract rents and spend public money on projects that are not in line with voters' preferences. In other words, they use the funds entrusted to them to pursue their own interests and to maximize their individual wellbeing. Thus, the principal-agent problem arises as the voters (the principal) and their

* Coalition governments are composed of several political parties, however, majority governments are formed by a single decision-maker.
political representatives (the agent) do not share the same preferences (Persson et al., 1997; Persson and Tabellini, 1999).

In addition, as all politicians spend money from the general fund and spending decisions are taken by different agents involved in the budget process in a decentralized way, the common pool problem may arise. Indeed, politicians tend to overestimate the benefits of public spending oriented to their constituencies as the financing costs of these expenditures are borne by all taxpayers and not only by the recipient region or group. In this context, it is important to highlight that the higher the number of politicians relying on the same general tax fund, the lower the marginal cost of distributive policies for each constituency and the bigger the public debt (von Hagen and Harden, 1995; Velasco, 2000).

The detrimental effects of the "common pool" and the "principal-agent" problems can be eased by budgetary institutions (von Hagen and Harden, 1995; Hallerberg et al., 2007; von Hagen, 2007). Political economy literature assumes that budgetary institutions impose constraints on politicians' behavior and influence their strategic choices. Hence, the "principal-agent" problems can be reduced by strengthening the accountability of political agents, more specifically by bringing them under control and inciting them to adopt transparent practices, while the "common pool" problem can be tackled by the centralization of the budget process.

Hence, political economy literature suggests four institutional approaches to mitigate deficit bias.

- Adopting fiscal rules
- Improving fiscal transparency
- Centralizing the budget process
- Creating an independent fiscal authority

6.1 Fiscal rules

The adoption of fiscal rules has been widely viewed as an effective remedy to deal with deficit bias and to control public debt (Foremny, 2014). Fiscal rules are generally defined as the set of limitations and numerical constraints on some budgetary aggregates. Balanced-budget constraints remain the most rigorous form of numerical targets. Fiscal rules may take a variety of other forms such as limits on spending and taxes and numerical debt ceilings. These varied numerical rules have been adopted in several countries. The United States and Canada have implemented almost all of the different types of fiscal rules, while the numerical debt and deficit limits have been used in Europe, in the context of the Maastricht Treaty.

Many studies have claimed that imposing constraints on the fiscal-policy making may improve fiscal discipline. Accordingly, Poterba (1996) found that the adoption of balanced-budget constraints in the United States has reduced significantly government spending. Similarly, Filc and Scartascini (2005) have shown, for a sample of Latin American countries, that countries with stricter fiscal rules maintain lower levels of budget deficit. Analyzing the effectiveness of fiscal rules in the European context, von Hagen (2006) has noted that the effect of numerical fiscal rules on fiscal outcomes varies from one country to another. Notably, fiscal rules are associated with limited spending and deficits in smaller countries and in those endowed with high-quality budgetary institutions.

However, it should be noted that strict numerical targets may foster the use of creative accounting and thus by shifting fiscal expenditures off the budget...
(Milesi-Ferretti, 2003). In other words, spending could be transferred to funds that are not subject to constraints. In this context, von Hagen and Wolff (2006) claim that the member states of the European Monetary Union often resort to this practice to hide their deficit. Hence, it is worth mentioning that imposing strict limits may not be effective, given that rules can be circumvented.

6.2 Fiscal transparency

Fiscal transparency has been seen by many researchers as one of the most appropriate tools used to ensure a better fiscal performance (Alt and Lassen, 2003; Benito and Bastida, 2009). In fact, fiscal transparency may overcome the principal-agent problem and limit the rent seeking behavior by holding decision-makers personally accountable for their actions. A number of definitions have been attributed to fiscal transparency. In this regard, Poterba and von Hagen (1999) point out that a transparent budget process is one that provides clear and publicly accessible information on government fiscal policy. Hence, making optimistic forecasts about certain macroeconomic indicators, overestimating the effects of new policies and using off-budget accounts and multi-year budgeting may reduce budget transparency (Alesina and Perotti, 1999). However, one of the most widely accepted definitions of fiscal transparency is the one suggested by Kopits and Craig (1998). In their opinion, fiscal transparency is the open access to information on government activities. As a result, reliable, comprehensive, timely, understandable and internationally comparable information allows for a more accurate evaluation of the costs and benefits of government’s activities and, hence, a more precise assessment of its financial health.

Interestingly, it should be noted that a transparent budget document that provides an accurate forecast of expenditures, revenues and deficits may help voters understand the government’s fiscal plans. Increased transparency also enables voters to compare the actual fiscal performance with the government’s past plans in order to verify whether policy-makers have honored their commitments (von Hagen, 2007).

Many empirical studies have shown that fiscal transparency improves fiscal performance (Alt and Lassen, 2006), reduces corruption (Reinikka and Svensson, 2004) and prevents creative accounting (Alt et al., 2012). Transparency is ultimately seen as a fundamental prerequisite for the implementation of fiscal rules. Thus, a high level of transparency encourages the government to comply with the fiscal rules (Debrun and Kumar, 2007). Furthermore, it is worth noting that the level of fiscal transparency is determined by domestic political factors and that a better fiscal transparency is often linked to holding free and fair elections (Wehner and de Renzio, 2013). Imposing some rules and regulations on how the budget should be prepared, organized and implemented and creating independent legislative bodies or a private institution responsible for checking and evaluating the accuracy and the transparency of the budget process may also enhance fiscal transparency (Alessina and Perotti, 1999).

6.3 Budget centralization

The common-pool problem and the resulting spending and deficit biases can be alleviated by prompting
politicians to take a comprehensive view of their decisions and to make a better assessment of the costs and benefits of their actions. Thus, more hierarchical procedural rules (Alesina and Perotti, 1999), or simply, more centralized budget process (Von Hagen, 2002) may improve the coordination between decision makers. Procedural rules are defined as the processes under which decisions on public spending are made. In other words, it refers to the set of rules governing decision-making with regard to the budget's formulation, approval in parliament and implementation. Each stage of the budget process involves different actors and specific roles are assigned to each of them. In the first stage, the draft budget is formulated by the executive. Then, the budget proposals might be approved by parliament with the possibility of introducing amendments to the budget. This stage ends with the adoption of the budget law. Next, the implementation stage consists of assuring that the allocated funds are in line with the approved budget. And finally, the final budget documents might be subject to audit and evaluation by an independent audit institution, such as an audit court. At different stages of the budget process, institutions can be more or less hierarchical (more or less centralized). More hierarchical/centralized rules are those minimizing conflicts of interest in the budgetary process.

In this context, Hallerberg and von Hagen (1999) argue that centralization follows two institutional approaches: the delegation approach and the contract one. The delegation approach advocates a special delegation of authority to the minister of finance in order to limit the conflicts of interest between spending ministers. At the stage of budget formulation, the finance minister is the one in charge of setting budget targets and drafting the budget proposal. The executive is vested with large agenda-setting powers even at the legislative stage since the legislature has limited powers to introduce changes on the budget. At the implementation stage, the finance minister is granted monitoring power and accordingly the right to prevent ministers from overspending and avoid the use of supplementary budgets. The minister of finance can even impose punishments for defecting spending ministers.

Under the contract approach, spending ministers negotiate on fiscal targets and take on the commitment to respect their agreements throughout the year. During the budget formulation stage, the role of finance minister is restricted to the simple evaluation of the consistency of the budget proposals prepared by spending ministers within the agreed spending limits. At the legislative stage, in contrast to the delegation approach which constrains legal budget amendments, the contract approach focuses on the role of the legislature in monitoring the compliance of executive's budget with the fiscal targets. At the implementation stage, the contract approach is similar to the delegation approach, considering that both monitoring and sanctioning powers are conferred on the finance minister.

The choice of one approach or the other depends on the number of political parties in government. The delegation approach is more appropriate for one-party governments while contract approach is more appropriate for multi-party coalition governments (Hallerberg and von Hagen, 1999). This could be explained by the fact that the members of a coalition government have different spending preferences and the delegation of the power to the finance minister may lead to a principal-agent problem.
as the former shares his own party's spending preferences. However, under contract approach, the fiscal targets are negotiated among the members of the coalition and such a problem may never emerge.

6.4 Fiscal councils

Fiscal council is an independent and autonomous body established by the government to assess fiscal policy and provide public financial guidance and fiscal advice (von Hagen and Harden, 1994; Debrun et al., 2009). The popularity of fiscal councils has increased in the last few years as many countries such as Sweden, Canada, Hungary, Slovenia, and the UK have set up independent agencies to insure the stability of their public finances and promote sound fiscal policies. The council's basic function is to disclose information on the maximum authorized increase in public debt. This declaration should be supported by a detailed account of the fiscal policy undertaken by the government.

The design of fiscal councils varies across countries in terms of institutional structures and assigned tasks. It depends on country-specific features, such as available human and financial resources, political traditions and the causes for growing deficits and debts (Kopits, 2013; Debrun et al., 2013; Debrun and Kinda, 2014). In this context, many studies have indicated that well-designed fiscal councils lead to improvements in fiscal performance through several channels (Calmfors and Wren-Lewis, 2011). First, by promoting budget transparency, fiscal councils may strengthen the government accountability and curb the opportunistic behavior of politicians. Second, by providing public assessments and budget forecasts, these independent agencies may raise public awareness about the macroeconomic effects of the existing fiscal policy. And third, as a monitoring body, fiscal council may prevent the government from circumventing numerical fiscal rules. In this regard, it should be noted that fiscal councils and fiscal rules are often considered as complementary. Hence, it is worth mentioning that the effectiveness of fiscal councils rests on their independence from politics, their credibility and their strong presence in media. More specifically, the ability of fiscal councils to increase public understanding of fiscal policy can help voters assess the competence and commitment of the incumbent government (Beetsma and Debrun, 2016).

7. Conclusion

This paper summarizes the recent literature on the political economy of fiscal policy. The models explaining budget deficits and public debt accumulation that have been given due attention, have been focusing on two main questions: the persistence of public debt and the cross-country differences in debt levels.

Theoretical argumentation suggests that the motivation behind deficits is linked to the opportunistic behavior of incumbents attempting to increase their chances for reelection, and also to their partisan preferences for large governments. In addition, the incumbent government may use deficits to influence the policies of successors with different fiscal preferences. Furthermore, the conflicts of interest between politicians of different parties and between generations may lead to larger deficits and debt levels.

This overview also underlined the importance of budget institutions. According to the political economy literature, high debt levels could be curbed
by adopting fiscal rules, improving fiscal transparency, centralizing the budget process and creating an independent fiscal authority. Budget institutions raise voters’ ability to monitor the government’s choices with regard to spending and taxation, which in turn prevents the electorate from being manipulated.

Numerical targets may reduce the ability of government to influence successors’ policies or to use fiscal policy to manipulate elections. Fiscal transparency may promote fiscal responsibility and limit rent extraction while more centralized budget institutions may prevent the fight for resources across political parties by limiting the number of participants in fiscal decisions. Finally, the creation of fiscal councils may improve government accountability and hinder the opportunistic behavior of incumbents.

This survey has paved the way for future studies aiming to empirically analyze the political and institutional determinants of public debt.

References


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