

Budgeting Procedures and Democratic Ideals

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ABSTRACT

The choice of rules for the central government budget process represents a trade-off between potentially conflicting goals. Budgetary reforms triggered by serious imbalances in public finances over the last two decades indicate that a political re-orientation has taken place, giving more emphasis to macroeconomic impacts, long-term budgetary restrictions, and transparency in budget decision making. The paper analyses a number of generic problems of collective decision-making in the fiscal policy area and their relation to fundamental values upon which democratic states are built. The discussion is illustrated by experiences from a major budget process reform in Sweden between 1992 and 1997. The conclusion is that tighter fiscal discipline can be achieved without encroaching upon democratic values; it is argued that democracy can in fact be strengthened by such a shift of regime.

A number of OECD countries experienced severe problems in public finances during the closing two, three decades of the 20th century. There were large differences within the OECD group, however. Whereas some countries maintained a roughly constant public debt-to-GDP ratio, others exhibited a swiftly rising debt ratio – a clear indication that the financial policy regime was not sustainable. A large theoretical and empirical effort has gone into explaining the differences between these two categories of countries. Although answers are as yet necessarily provisional, it is quite clear that the explanation cannot be found exclusively within the economic sphere. Rather, it is in the interaction between macroeconomic events and democratic institutions that the answers must be sought.

In a reform perspective, some explanatory factors are more interesting than others. Although the relative importance of international macroeconomic shocks or political culture carries a general interest, neither of these factors is open to change in the short to medium-term perspective. By contrast, rules and institutions are. To states in a more or less acute financial crisis, the central question quite naturally has been, “How can we change our budgetary institutions so as to stabilise, and in the long run reduce, the debt-to-GDP ratio?” Within the group of European countries heading for the third phase of the EMU, this issue became all the more vital as a debt ratio not exceeding 60 per cent was imposed as a formal requirement for membership. The Maastricht treaty (Art. 3 of the Protocol on the Excessive Deficit Procedure) further spelled out an explicit condition on the member state budget process: “The Member States shall ensure that national procedures in the Budgetary area enable them to meet their obligations in this area deriving from this Treaty.”

Assuming that changes of the desired nature can in fact be accomplished by institutional reforms, it is natural to ask whether there is a cost associated with such changes, in the form of less scope for democratic control of public decisions. In order to analyse this question, it is necessary to investigate in some detail what happens when a major institutional reform of this kind is launched. The analysis to follow is based on what could be characterised as a balanced rational-actor perspective. It starts from an orthodox description of collective decision-making as an aggregation of preferences among fully informed individuals. Gradually, this stringent assumption is relaxed to allow for a more realistic description of the process.

The analysis is illustrated by an account of the Swedish budgetary reform carried out during the mid-1990's. The reform project has some interest in itself, as an illustration of what is possible in the area of institutional change, but the main motive is to show at a relatively detailed level how decision-making is affected by a change in the institutional environment. Every important component of the reform package is the answer to one or several of the generic problems associated with collective decision-making in the fiscal policy area. Only after this understanding has been gained is it possible to address the basic question –

whether democratic values are in any way threatened by the kind of reform at issue.

The outcome of an evaluation is of course critically dependent on the criteria chosen. We will use a three-dimensional conception of democracy – majority rule, constitutionalism, and efficiency (in a sense to be made precise) (see §3 for an elaboration).

1 Generic problems of budgetary decision-making

The nature of institutional change

Rules defining an institutional setting are normally spread across several levels of the regulatory hierarchy. Budgetary rules form no exception. The constitution lays down the fundamentals – the right of the parliament to tax the citizens and to decide on the use of public resources. At the other end of the spectrum, a large number of ordinances specify rules for the handling of public money by agencies – accounting practices, audit, and so on. The link between these two sets of rules is in most countries a budget act (*loi organique*), which collects the main rules of the detailed framework in condensed form.

There is now a rich literature devoted to the relationship between institutions and fiscal policy outcomes. Some studies have concentrated on the fundamentals of the political institutions, such as the voting system (Grilli et al. 1991, Lijphart 1999) or the party structure and average tenure of government (Roubini & Sachs 1989). An increasing number of studies have focused on the lower strata of the regulatory hierarchy governing public financial decision-making. There is now evidence from Europe (von Hagen 1992, von Hagen & Harden 1994), the United States (Poterba 1993), Latin America (Stein et al. 1997), and Asia, that testifies of the importance of the institutional setting for fiscal policy outcomes.

Why do institutions make a difference? The answer will of course depend on the institution under study, and in general also on what assumptions are made about the persons affected. It is known, for instance, that even among rational, fully informed individuals, voting order may affect the outcome. If the assumption of

fully informed individuals is relaxed, there are many ways in which outcomes may be affected – some aspects may be highlighted or downplayed by the procedures used, the balance between common and particular interests may be altered, and so on.

The present section analyses these effects in the area of budgetary decision-making, starting from the stringent condition of fully informed, rational individuals and then gradually relaxing this assumption. Five categories of problems are analysed:

- i. *Aggregation of preferences among fully informed individuals.* This is the most extreme version of the rational-actor model, assuming complete and consistent preferences among the decision-makers. In this case instabilities or no-decision situations may occur.
- ii. *Prisoners'-dilemma situations.* This model recognises the potential gap between individual and collective rationality. The very concept of rationality is in these cases ambiguous.
- iii. *Decision problems with long horizons.* These dilemmas may occur even without social interaction (Robinson Crusoe decisions) and stem from the potentially indeterminate trade-off between current and future gains and losses.
- iv. *Decisions under uncertainty.* All decisions are fraught with uncertainty. Empirically, attitudes to risk are not always consistent with standard rational-actor assumptions. Further, uncertainty may be unstructured and therefore unsuited for the kind of analytical tools that the standard framework relies upon. Again, these problems may arise in the absence of social interaction.
- v. *Principal-agent problems.* Both public decisions and the implementation of such decisions normally rely on some division of labour between a principal and an agent. In these, situations, information is incomplete and asymmetric, and standard results from rational-actor theory do not apply.

The above list does not claim to be exhaustive, but it does cover a wide range of generic problems in collective decision-making. Remedies are discussed in

connection with each category of problems. Because a given remedy will often have effects in more than one dimension, there is necessarily some overlap.

Preference aggregation among rational individuals

The simplest rational-actor models of budget choices picture them as the selection of a point in an n -dimensional policy space. The number n corresponds to the number of items on the budget and is consequently large (typically 1000). Each decision-maker is assumed to have a preferred point in this high-dimensional policy space. A decision-maker prefers one alternative to another if the former is closer (using some suitable distance in n -space). The budget decision consists in finding an alternative (corresponding to a point in the policy space) that is supported by a majority and represents a stable equilibrium. As could be expected from well-known Arrowian impossibility results, it may occur that no equilibrium exists, and some early analyses did establish negative results (Plott 1967, McKelvey 1976; for a survey, see Nurmi 1998). Schofield (1980) showed that the non-existence of equilibrium was typical in a sense that can be made mathematically precise. More recently, Banks (1995) has corrected earlier proofs and shown that if the number of policy dimensions n exceeds $(p+1)/2$, where p is the number of decision-makers, there is in general no majority rule equilibrium. A straightforward application to budget voting in Swedish parliament, where the number of appropriations is currently around 500 and the number of MP's 349, would lead us to expect a no-equilibrium situation.

The above exercise may appear to be mainly of academic interest but is nonetheless relevant to real-world issues. The important message is that there is in any context of collective decision-making a risk of instability, and that this risk is associated with the number of alternatives as compared to the number of voters. More precisely, the risk of a no-decision situation is greater the greater the number of dimensions of the decision to be taken. When the number of dimensions is reduced to one, stability prevails, and we have the classical median-voter outcome first derived by Black (1958).

In real-life, voting in parliament is individual only in principle, given that parties govern voting on most issues. The number of actors would equal the number of parties in the first approximation, assuming that parties behave like monoliths (which is of course an oversimplification). Votes on different issues are not uncorrelated; some coherence is ensured by ideology, which eliminates a large number of completely erratic combinations. In practice, both n and p will therefore be smaller than the numbers given above. Independently of these givens, the possibility of reducing the number of dimensions of the budget decision remains an interesting alternative for reducing the risk of instability.

Another approach to countering the threat of instability is to impose a voting order that singles out a winning alternative, normally at the price of being dependent of the agenda-setter's preferences. Simple low-order examples can be analysed to find out whether top-down or bottom-up voting procedures would lead to the lowest expenditure levels. Assume for instance, as in McCubbins & Schwartz (1985), that three parties in parliament vote on two expenditure items. They may proceed either by first voting on total budget size and then on the two items, or by voting on the two items separately and arriving at the total expenditure as a sum of the two items. It is straightforward to show that in general, the outcome will be dependent on the voting procedure, and secondly, that a top-down procedure can sometimes lead to a higher expenditure level than a bottom-up procedure. It is consequently an empirical question which procedure will lead to the lowest expenditure level (see Helland 1995).

The budget decision as a prisoners'-dilemma

A real budget process is much more than a single decision in parliament. Preferences are not given but shaped in a deliberative process, and they reflect partly conflicting objectives among decision-makers. Members of parliament have limited knowledge about the issues they decide on, and the picture is marred by considerable uncertainty about important variables (macroeconomic assumptions, behavioural change among socially insured, etc.). Such complicating factors must be taken into account when analysing the effects of a budget reform.

First of all, a gap separates collective rationality from individual or group rationality. Ties to sectoral or regional interests may pose a problem. Benefits from public undertakings can be designed so as to accrue to limited groups, whereas costs are distributed over all taxpayers, and so we are faced with a common-pool problem or a *prisoners'-dilemma* (see e.g. Hallerberg & von Hagen 1997). Unless a norm or an institutional arrangement in some way compensates for this asymmetry, there will be a bias towards overspending in the public sphere.

Logically, there are three solutions to the prisoners' dilemma. The situation may be such that the players involved consider it in their *long-term interest* to cooperate. If not, they must decide to act against their own perceived interest, either by following a *norm* or by being *forced* to choose cooperatively. There is a widespread belief that continued interaction is in many cases sufficient to ensure cooperation (Axelrod 1984). This belief is based on generalisations from two-person games that seem difficult to defend, however (Molander 1992a; see also Binmore 1998 for critical remarks). In general one would therefore have to resort to norms or rules in order to ensure co-operative behaviour.

There is a voluminous empirical literature on factors that foster cooperation in dilemmas of this character. The *framing* of the decision situation is important (Eiser & Bhavnani 1974, Marwell & Ames 1981, Frank et al. 1993). In experiments with varying *incentives*, common-sense hypotheses have been confirmed (Rapoport & Chammah 1965), and repeated games exhibit a higher degree of cooperation as expected (Slusher et al. 1974). *Groups* as decision-makers tend to cooperate less (Pines 1976). It is an important fact for the design of institutions that physical *proximity*, *information* and possibilities for *communication* seem to enhance cooperation (Sensenig et al. 1972, Swensson 1967, Fox & Guyer 1978).

Studies of single factors as the above-mentioned may be put together when designing the institutional environment in which collective decisions will be taken. Real-life, rather than experimental, studies of long-standing cooperation confirm that factors such as these play an important role (Ostrom 1990, 1992; Bromley (ed.) 1992). Creating a common arena where individual or group choices

are exposed and have to be defended in public leads to what Goodin refers to as *preference laundering* (Goodin 1986). Transparency is thus a general instrument that helps to maintain a generalised observer's perspective and makes it more difficult to forward narrow group interests.

Exogenously given rules (such as the Maastricht criteria in the fiscal policy area) may help to maintain cooperative regimes in some situations. They are somewhat risky in the parliamentary context, however, given the importance attached to sovereignty by national assemblies and electorates. Other arrangements, such as extending the domain of responsibility of parliamentary standing committees, may strengthen a generalised observer perspective (Hall & Grofman 1990), thereby internalising some of the aggregation problems.

Long-term effects

According to the standard rational-actor model, future costs and gains are supposed to be aggregated using a discount factor. Empirical research indicates that a substantial fraction of a population does not maximise their long-term welfare in this sense, and that there is a tendency to overvalue short-term benefits and to underestimate long-term costs (Akerlof 1991; further references in Elster 2000). As long as only one single individual is concerned, this may not be a serious problem, but in collective decision-making it may become one because of the generally uneven distribution of costs and gains over time. In the area of fiscal policy, the risk of *fiscal illusion* is a matter for concern (Buchanan & Wagner 1977) – benefits are visible as short-term gains, whereas costs are diffuse, and when it comes to the excess burden of taxation, difficult to estimate even for specialists. What complicates the matter further is that future generations do not take part in the decisions, whereas they may be affected by today's policy choices. The classical *demos* problem reappears here in a version that cannot be resolved via a simple extension of the right to vote.

The choices associated with the design of budgetary institutions reflect classical, or even existential, dilemmas of self-binding. The individual or the collective may

gain in the long run from sacrificing some freedom of action in the short run. As in the hackneyed metaphor of Ulysses and the sirens (Spinoza 1670, VII.1; Horkheimer & Adorno 1947; Elster 1984), it may be a question of survival, but in most cases the choice is less dramatic and concerns cost and gains in the near and a more distant future. The choice of budgetary rules is consequently similar in kind to constitutional choice in general, with all the complications that go with it. Choosing rules for future decision-making is very different from making actual policy choices in a given situation. In the political arena, the matter is further complicated by the possibly uneven distribution of costs and gains. As remarked by Seip (2000), binding others rather than oneself is perhaps the overarching goal in the context of practical constitutional politics.

Irrespective of the origin of such bindings, they do play an important role in political decision-making. A medium-term commitment to a measurable target helps to manage fiscal policy in the short run. The electoral period intervenes in a slightly paradoxical fashion; longer terms give the incumbent more freedom of action but simultaneously strengthens accountability. The latter effect is stronger than the former, and the relationship between electoral periods and government debt is negative (Grilli et al. op. cit.). For longer time-spans, generational accounting has been suggested as a means to maintain intergenerational fiscal responsibility (Kotlikoff 1992).

Uncertainty and ignorance

The basic model of rational decision-making is impossible to implement in practice. In order to survive in everyday life, man must resort to heuristic devices; rationality is bounded (Simon 1996 (in particular chapters 3 and 4), Rubinstein 1998). These intellectual shortcuts may be quite efficient in reducing complexity, as they are continuously tested and more or less explicitly evaluated, but they may also lead to severe and systematic bias in everyday decision-making. One important role for institutions is to moderate, if possible eliminate, such bias.

Decision-making in the public sphere is fraught with uncertainty. Behavioural responses to policy change, long-term versus short-term effects, partial (or *ceteris*

paribus) versus aggregate effects are examples of general uncertainty problems that are important to policy decisions. Judgement under uncertainty is known to suffer from systematic errors because people tend to rely on a limited number of heuristic principles. Sometimes genuine misconceptions are a source of bias (for a survey, see e.g. Kahneman, Slovic & Tversky 1982). Among the errors and biases of particular relevance to the political sphere are availability or salience errors, anchoring, and asymmetries in the perception of gains and losses. *Availability* bias means that the importance of certain outcomes is overestimated because they are associated with particularly salient examples. Likewise, the absence of signals from a certain set of outcomes will lead to an underestimate of its importance. The logic of media reporting is particularly relevant in this context.

Anchoring is the tendency for observers to stick to their perceptions in the face of information that calls for a revision. Empirical research illustrates to what extent observers are able to ignore or explain away evidence that is incompatible with their prior ideas about facts and relationships (Edwards 1968). This perseverance is of course particularly relevant in the political field, where observations are biased by interests and ideology.

Asymmetry, or the tendency to assign relatively greater weight to losses than to gains, is another generally observed phenomenon (Kahneman & Tversky 1979). In the political sphere, this leads to a status quo bias (Weaver 1986).

That the public is ignorant in political matters is one of the truly stable observations of empirical political science. Ever since the classical study by Converse (1964), the results have been confirmed and re-confirmed (Zaller 1992, Delli Carpini & Keeter (1996), Friedman 1998). The evidence concerning political decision-makers is more anecdotal, for the simple reason that politicians rarely line up to have their knowledge about basic political facts scrutinised. Voters and politicians lack basic knowledge about important issues because these issues are not perceived as central to the fields on which they have chosen to focus – “out of sight, out of mind”. Unless decision-making procedures force them to improve their knowledge, they may be able to manage quite well.

Lacking basic knowledge, the decision-maker cannot be expected to form coherent preferences. The rationalistic model assumes that preferences are given,

thus ignoring the important process of preference formation. Not only can preferences in political as well as other spheres be modified during a deliberative process; in many cases it is more reasonable to assume that individuals do not have any explicit preferences at all in a certain field than to assume the opposite. Again, institutional arrangements may contribute to the conscious formation of preferences, thereby eliminating important lacunas.

The general antidote to uncertainty and ignorance is *information*. But availability is not the main problem; there is in general no dearth of information that prevents political decision-makers from developing or defending sustainable fiscal policies. The question is rather to what extent the procedures used force decision-makers to acquire new knowledge and develop a deeper understanding of the implications of various alternatives open.

The problems of availability and anchoring are both examples of misrepresentation, and can be corrected by information that is as far as possible unbiased. To integrate such information into the decision process, it may be necessary to institutionalise both production and dissemination of such knowledge. This may be accomplished as in the U.S. case with the aid of a congressional budget office for information *ex ante*, and using audit and evaluation institutions for information *ex post*. The decisive condition in this context is whether there is a designated recipient of the information in question whose task it is to react to the information put forward. Absent such an addressee, the information produced may have little or no effect on actual decision-making.

The problem of asymmetry in the way gains and losses are perceived is somewhat different by nature. As the main effect is to strengthen the status quo, the most important countermeasure is to question current policies systematically. A full-fledged annual zero-base budgeting procedure is not a feasible alternative, but recurrent attempts to reconsider policies should be made.

Principal-agent problems

The fact that democracy in most modern nations is representative reduces the practical problem of aggregation substantially. On the other hand, representative democracy creates a *principal-agent problem* (see e.g. Dixit 1998). Politicians have other incentives than just transforming the preferences of their voters into collective decisions at the national level. Bonds to partisan groups or personal career ambitions may interfere with the political mandate.

The principal-agent problem permeates the whole public sphere. Voters delegate power to political representatives in parliament. In parliamentary systems, these in turn elect a government (or possibly a Prime Minister). The government has an administration at its disposal to develop and implement policies. Each link in this chain represents a potential problem because of incomplete contracts (in a general sense) and asymmetric information. The formulation of the task to be performed always suffers from lack of precision, and the agent knows more than the principal does, both about the current state of affairs and about his own performance.

In general terms, it is fairly easy to formulate what is needed to cope with the principal-agent problem – a clearly formulated contract, complete and reliable information, and efficient mechanisms of accountability. Implementing this program is far from an easy task. Contracts between voters and politicians are necessarily incomplete, even if attempts at more concrete and measurable commitments are sometimes made at the local level. Reporting systems, evaluation and audit put information at the principal's disposal and may be an efficient tool assuming that the information is produced independently and in the principal's perspective. Good feedback mechanisms can to some extent compensate for inadequacies in the other two respects. Elections every four or five years is a strong but somewhat blunt instrument; the more permanent threat of a vote of non-confidence or internal audits and dismissal of high officials is more efficient in this respect.

2 Swedish budgetary reform 1992-97

Sweden experienced a deep financial crisis during the early 1990's (Diagram 1). The public sector financial balance fell from a surplus of 5 per cent of GDP in 1989 to a deficit of 12 per cent in 1993.

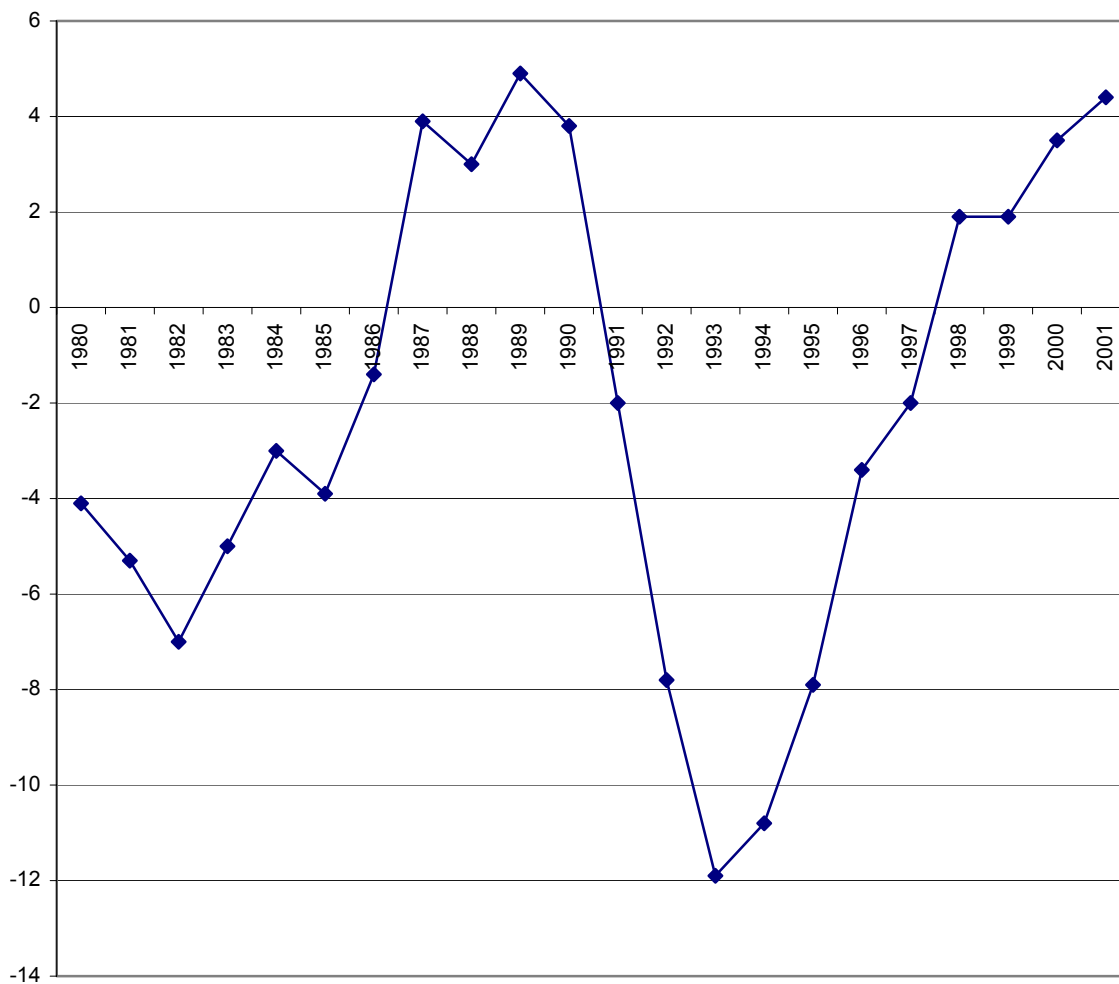


Diagram 1: Swedish public sector financial balance in relation to GDP (%)

A budget process reform package, presented to Parliament in 1995, was to some extent triggered by these events. The design of the reform relied to a considerable extent on results from comparative research carried out up to the early nineties, in particular von Hagen (1992), but experiences from single countries such as the Netherlands, Norway, and the UK were also exploited. The background and main components of the reform have been discussed in detail elsewhere (Molander 1999), whence the description here will be limited to the bare minimum.

The investigation carried out by von Hagen (1992) for the EC Commission was based on detailed information about the budgetary processes in the member countries, and a statistical test was used to develop a structural index that summarises the main features of the budget process. The index explains about 30 per cent of the variation in public deficit among the member countries during the period studied. One point on the index scale corresponds to just above 0.9 per cent of GDP in steady-state government debt; strengthening the budget process by 10 points on the index scale can thus be expected to reduce the steady-state debt by about 9 per cent of GDP.

The same analysis was carried out for Sweden (Molander 1992b), the result being that Sweden ranked second-last between Italy and Greece (see Diagram 2).

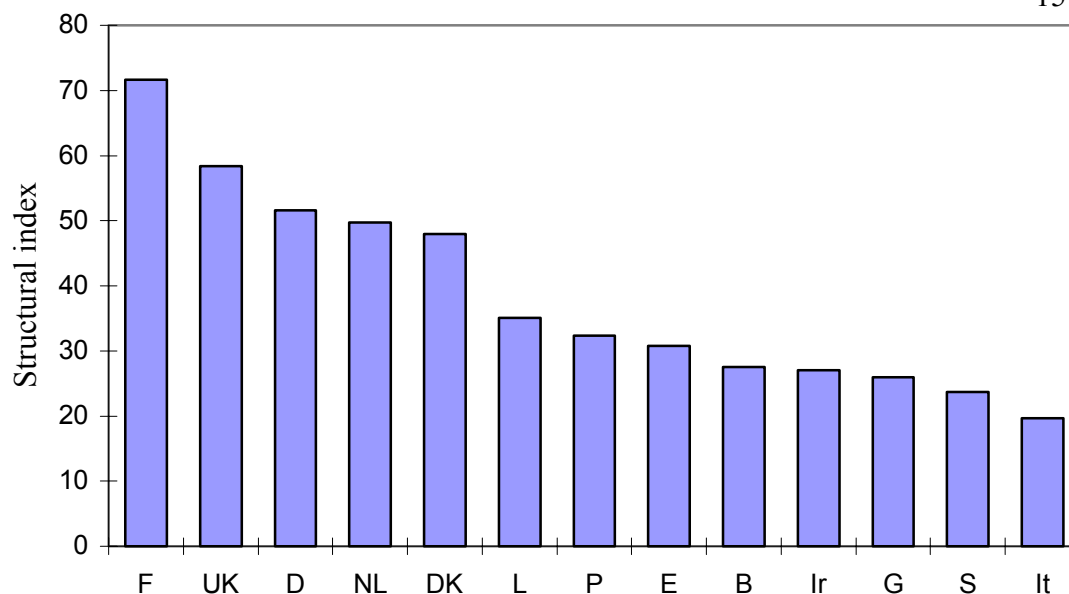


Diagram 2: Structural indices for the budget processes of the twelve EC countries and Sweden in 1992

This triggered a reform process in both parliament and government, and a new and stricter budget process was in force as of January 1st, 1997. The main components of the reform package were:

- an orthodox top-down budgeting procedure starting from fiscal policy goals at the aggregate level;
- a nominal, tri-annual ceiling for state expenditures;
- dismantling of open-ended appropriations;
- a complete state budget based on the gross budgeting principle (no netting of expenditures against revenues);
- improved forecasting;
- comprehensive in-year follow-up of expenditures relative to budget figures;
- improved performance measurement, aiming at a comprehensive set of indicators;
- a budget act, specifying the freedom of action of government vis-à-vis parliament in the fiscal policy area.

Every important component of the reform package can be seen as the answer to one or several of the generic problems treated in the previous section and will be

presented under the same headings below. For a more process-related presentation, the reader is referred to Molander (1999).

Aggregating preferences

The new central government budget process represents a textbook application of *top-down budgeting*. In that respect, the changes illustrate a general tendency among countries that experience severe financial crises (Bozeman & Straussman 1982). Budget preparation starts from macroeconomic projections and forecasts for expenditures and revenues under a no-change assumption, and derives the need for expenditure cuts or revenue increases based on previously stated budgetary restrictions such as the Maastricht conditions or self-imposed balance requirements.

A second important component is an *expenditure ceiling* voted by parliament each spring for the three following years. The expenditure ceiling is rolled each year, so that unless exceptional circumstances prevail, the ceilings for the first and the second year of the decision period are inherited from previous year's decision. The ceiling is nominal (i.e., not adjusted for changes in the inflation rate relative to the forecast on which the budget is based), and covers all state expenditures except interest on central government debt. State expenditures are divided into 27 expenditure areas. The number of appropriations is about 500.

The top-down approach is reflected also in the way parliament votes on the budget. Voting starts from above, with a vote on the ceiling and the frames for the expenditure areas. Following this decision, parliament treats the budget at the appropriation level. During this second stage, the first vote is binding, so that any proposal for change in an expenditure area has to be balanced by expenditure cuts within that particular expenditure area.

Relating to what was previously said about the number of dimensions, it is clear that this two-step procedure drastically reduces the risk of decision cycles or no-decision situations. Instead of 500 appropriations, parliament now votes on 27 expenditure areas comprising on the average about 20 appropriations each.

That the vote on the aggregate and the budget frames for the expenditure areas precedes the votes on single items forces MP's to argue for amendments against the interest of other MP's. This implies a (potentially high) cost for amendment proposals. It also requires any party or group arguing for higher expenditure levels to argue their case in the first vote, which presumes a high level of coordination within the parliamentary opposition. Similar changes have been made in the preparatory phase of the budget process, to the effect that cabinet members wishing to increase the size of the budget find themselves in a similar position as MP's in parliamentary standing committees.

Another important consequence of a two-step procedure is that even a minority government not too far from the political centre has a good chance of having its budget proposal accepted by parliament, at least as far as the main parameters go. Voting in the standing committee on finance proceeds by eliminating extreme alternatives and leaves a main alternative to the government proposal. Committee members normally abstain from voting rather than support an alternative that they have not put forward themselves. By consequence, it takes a united opposition left and right of the government to vote for an alternative – a most improbable outcome. In a sense, the new process combined with established voting practices almost reduces the problem to a vote on the size of the public sector, which, according to Black's classical result, leads to a stable median voter outcome.

Incidentally, Norway carried out a budget reform in the late 1990's inspired by the Swedish model. The effect is somewhat different, however, because Norwegian parliamentary practices require that committee members vote on all alternatives; abstention is not permitted. The government must therefore collect a majority for its budget alternative, whereas in Sweden it is sufficient that no alternative gets more positive support – a considerably weaker condition. The micro rules of committee voting thus have profound implications for the power balance at the macro-political level (Rasch 2000).

Managing the prisoners' dilemma

The first and perhaps the most important change is that cabinet members and members of parliament are forced to take a stand on the overall size of the budget. It is no longer possible to remain silent on this issue and to limit one's political platform to any particular sector or region. There is reason to believe that this is an essentially new step for many politicians. In order to forward more narrow interests, a minister or an MP must argue against the trade-offs represented by the coherent alternative presented by the minister of finance or the government, respectively. This can be done either by raising expenditures or lowering taxes, thus impairing the fiscal balance, or by raising expenditures for some purpose and simultaneously lowering expenditures elsewhere within the same expenditure area. No matter what strategy is chosen, the costs of counterproposals is raised.

The importance of physical proximity mentioned (Sensenig et al. op. cit.) is exploited. The basic budget proposal presented by the minister of finance is discussed in the cabinet circle at a conference during which cabinet members are locked up on their own, and literally have to face one another when arguing for higher expenditure levels within their own domains of responsibility. Such a procedure is conducive to cooperative behaviour, and is also likely to engender solidarity with the overall budget once an agreement has been reached.

The expenditure ceiling has a similar restraining effect on entitlement proposals. Imposing a ceiling on an expenditure system that is partly driven by entitlements is liable to generate tensions. The potential conflict between budgetary restrictions and expenditures generated by laws outside the budgetary system is ubiquitous, and the way this conflict is handled is perhaps the single most important defining characteristic of any budgetary system. Typically, two thirds of state expenditures in OECD countries are related to entitlements, mainly in the social security domain (von Hagen & Harden 1994). Obviously, a simple cash limit is an inadequate instrument to handle the conflict. What is called for is a reporting system that monitors all expenditures and alerts the government to potential overruns. When necessary, the government must then propose changes in the legal framework to parliament to prevent overruns, or alternatively compensate by

cutting expenditures elsewhere. Only via an early warning system of this type can entitlements be managed in a way that combines respect for legally bound commitments with the need to accommodate expenditures to overall budgetary restrictions. The incentive to put forward under-financed proposals is weakened compared to a system where entitlement appropriations are open-ended.

Increased *transparency* was a crucial element of reform. The budget covers all state expenditures, with some minor exceptions. Budgeting follows the gross principle; that is, expenditures in areas financed partly by fees are not netted against these revenues. Tax expenditures are reported annually in order to counteract temptations to expand less visible subsidies on the revenue side of the budget.

The role of the Maastricht criteria is interesting in this context, because of their potential role as externally imposed measures to coerce into cooperation over fiscal policies. In the countries heading for the third phase of the EMU, they have been used extensively to justify unpopular measures – a risky strategy, given the relatively low legitimacy of the Union in the electorate of the member countries. It may be of some importance that the Swedish parliamentary majority has voted for an adherence to the Maastricht criteria despite the fact that Sweden so far has opted out of the third phase. In this way, the criteria take the form of true self-binding rather than exogenously imposed constraints. There is strong reason to believe that the type of restriction represented by an expenditure ceiling voted by parliament and self-imposed Maastricht criteria has a better chance of survival than mechanical limits on deficit or borrowing, too easily circumvented by bookkeeping tricks (Meyers 1996).

Extending the time horizon

The Swedish constitution prescribes that the budget decision be annual, as do most constitutions. The annual vote on a tri-annual expenditure ceiling consequently has no particular status supported by the constitution, but is simply an ordinary parliamentary decision. Nonetheless, it strengthens the multi-annual perspective and reduces the risk that a non-sustainable fiscal policy regime

develops. Even in the presence of such a restriction, the risk of large deficits remains; some policy choices (e.g. state guarantees, or the design of a public pension system) have an inertia that goes beyond the three-year horizon.

Simultaneously with these changes the *electoral period* was prolonged from three to four years. Although this was done partly for other than fiscal policy reasons, it makes it easier for the government to take a longer view and maintain a sustainable regime.

A system of generational accounting was considered but turned down on the grounds that uncertainties are too large for this type of accounting to be used as operative decision support.

Coping with uncertainty

As already mentioned, a top-down procedure forces cabinet members and members of parliament to take a stand on the whole budget. This creates a strong incentive to acquire broader knowledge, including aggregate policy parameters. Information about the current state of affairs has been improved by explicit, multi-annual projections for expenditures and revenues, and improved in-year reporting both to the government and to parliament. In the latter case, the budget act requires that the government suggest countermeasures in case overruns are foreseen. Improved annual reports for all state agencies, including a consolidated annual report for the state, is another important component of the transparency enhancing strategy. Performance indicators better adapted to the needs of members of parliament than traditional ones are constantly being developed.

The forecasting problem must be handled with care when designing an expenditure ceiling. Cash limits are out of the question for most appropriations; entitlements normally cannot be made dependent on how many citizens or companies qualify for them. There is consequently some uncertainty attached to any system of benefits, which may be small or large. For this purpose, so-called flexible appropriations have replaced previously open-ended ones, which are obviously incompatible with the very idea of an expenditure ceiling. Because of the law of large numbers, forecasting uncertainties at the aggregate level are much

smaller than at the appropriation level. Even so, there is need for a budgeting margin. This was initially set to 1.5, 2, and 2.5 per cent for the first three years, respectively. This turned out to be quite adequate in principle. Contrary to purpose, this margin has been exploited for political purposes by raising the underlying level of expenditure. In this way, there was little room left for stochastic fluctuations in 1999, but the constraints were nonetheless on the whole respected.

Principal-agent problems

The budget act, in force as of January 1st, 1997, summarises the competencies of government in the financial area and thus clarifies the “contract” between parliament and government. Similar contracts between the government and the agencies have existed for a long time in the form of issue letters, but are continuously being made more precise as more performance indicators are developed or improved.

Transparency enhancing measures that alleviate some of the principal-agent problems have already been mentioned.

The national audit institutions were left untouched by the reform, but are currently (winter 2000) discussed in the perspective of strengthened accountability. An autonomous auditing institution under parliament will most likely be the outcome of this process.

Summary

A re-evaluation of the budget process according to von Hagen’s yardstick yields a post-reform increase of the structural index by about 30 points. This puts Sweden on a par with the UK and Germany and corresponds to a reduction of the steady-state government debt by approximately 30 per cent of the GDP, or the equivalent of 50 billion USD (see Diagram 3).

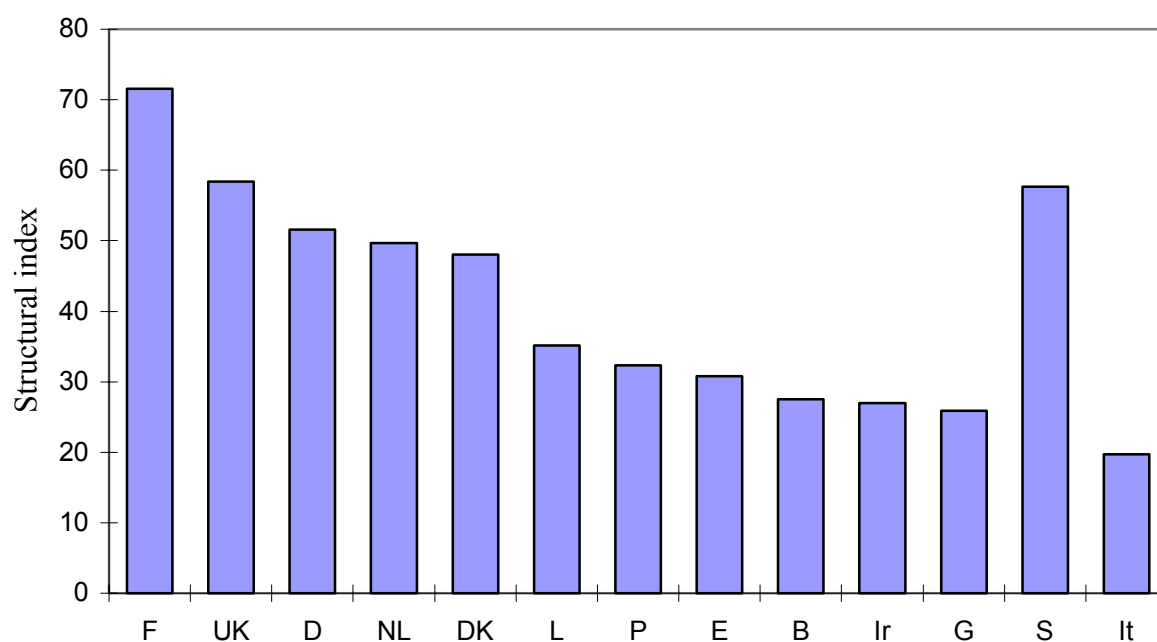


Diagram 3: Post-reform structural indices for Sweden in 1996 and other EU countries (not updated)

A look at Diagram 4 shows that, following the stabilisation period in the mid-1990's, public expenditures relative to GDP have decreased from the peak value of 70 per cent to a projected value of 53,5 per cent for 2001 (National Institute of Economic Research 2000). A comparison with Diagram 1 shows that practically the whole financial gap at the early 90's has been closed by reducing the expenditure level relative to GDP. This instils some hope that the improvement will be stable; as shown by Alesina and Perotti (1996), financial reconstruction programs that rely to a large extent on increased revenues normally do not yield lasting results.

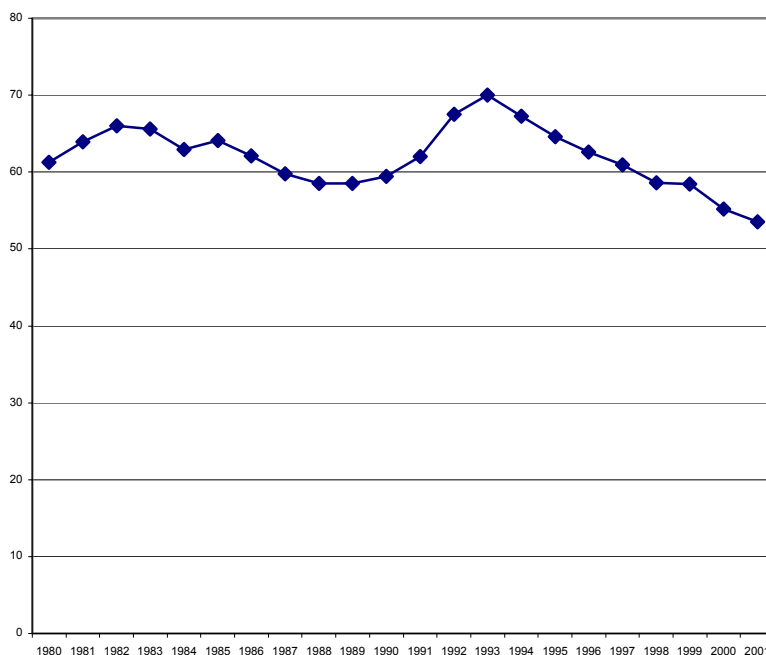


Diagram 4: Swedish public expenditures in relation to GDP (%)

The loyalty to the new regulatory framework has been satisfactory. A few minor items have slipped through in the form of tax expenditures, but the volume is small in comparison to the overall expenditure level (fractions of a per cent). The new budget process is currently (autumn 2000) being evaluated both by the parliament and the government. No substantial changes are foreseen.

3 Budgetary reform and democratic ideals

Democracies are traditionally evaluated along the two dimensions of *majority rule* and *constitutionalism*. The first dimension refers to the obvious requirement of popular influence over political decisions. This influence can be channelled in many ways – proportional versus majority rule, presidential versus parliamentary systems, etc. There are no two democracies that are identical in all respects relevant to the exercise of public power; the important common requirement is

that voters have a decisive influence and a possibility to correct mistakes by deposing power holders.

The second dimension, *constitutionalism*, expresses the requirement that the exercise of public power be bound by laws. Restrictions on the exercise of public power can take many forms – they may be procedural or substantial, they may rely on retarding mechanisms such as a bicameral parliament, and so on. That public decisions take the form of law rather than discretionary decisions gives some assurance of equal treatment of citizens, thereby precluding certain types of very specific benefits and sanctions. Constitutionalism is often presented as a restriction on majority rule. In a generalised-observer perspective (whether backed up by an ‘original-position’ framework or not), the situation may be different. Constitutional rule can in fact be seen as a democratic value in itself.

As stressed by Elster (1988) there is a third important dimension of the democratic universe – *efficiency* (see also Petersson et al. 1996). Whether efficiency should be considered as a mere restriction on majority rule or as a value in itself depends on the sense in which the word is used. Productive efficiency of the public sector is best viewed as a restriction on the implementation of public decisions. But there is a deeper sense of the word. Systems of majority rule are of limited value unless necessary public decisions are actually taken. Cycles or stalemates threaten the legitimacy of a democratic system. In this deeper sense, efficiency does carry an intrinsic democratic value.

Attempts have been made to link the above three dimensions to the three main components of the state – the legislature, the courts, and the executive – but this is too simplistic. Efficiency refers both to the decision-making procedures as such and to the implementation phase following the decisions.

The design of democratic institutions represents a three-cornered dilemma, given that the three goals are partly conflicting. On the other hand, existing trade-offs are not necessarily efficient, so there may be room for improvements in one or two dimensions without sacrificing anything in the third.

The discussion follows the same format of analysis as the preceding sections.

Majority rule

The transition from a bottom-up to a top-down procedure is of limited importance in itself. Changing the voting order neither increases nor decreases popular influence over the budget decision. Different democracies represent different ways of aggregating political preferences – majority versus proportional elections, unicameral versus bicameral systems, and so on – which gives no reason for characterising one system as more democratic than another. The general message from the theory of voting is that the ideal democratic system does not exist, and that the choice of procedures basically amounts to deciding which imperfections are the easiest to live with.

The indirect effects of the transition are all the more important. Top-down procedures force MP's to develop a more profound understanding of the implications of their decisions. Trade-offs between benefits of public consumption and transfers versus direct and indirect costs of taxation are made explicit, as are trade-offs between various types of public expenditure within a given budget frame. It is important for the legitimacy of the decisions taken that both the aggregate level and the single appropriations affected by expenditure cuts can be defended. Preferably, such packages should be presented jointly, supplemented by an analysis of the effects on the distribution of disposable income.

Will an expenditure ceiling imply that a bias against certain expenditures is somehow built into the budget process, that is, that the aggregation of preferences will be biased? (This was suggested in the debate over the expenditure ceiling in Swedish parliament; see Committee on Finance 1995). It is certainly true that an expenditure ceiling makes it more difficult to evade preferences associated with a sustainable fiscal policy. Whereas it is also true that there is a potential conflict between social security entitlements and budgetary restrictions, this conflict will materialise only if entitlements have been decided upon without proper analysis of the medium-term expenditure development. To the extent that a stricter process forces the government to supply a more realistic expenditure forecast, it strengthens democracy rather than weakens it.

A two-step procedure in itself does not preclude any budgetary decision taken under the previous regime. During the first decision stage, any MP or party may propose a different fiscal balance, different expenditure levels, or a different repartition among the expenditure areas. During the second stage, the distribution over appropriations within each expenditure area is again open to discussion. The difference with respect to a conventional procedure is that under-financed or non-financed proposals become much more visible, and that proposals financed via reduced expenditures require that the proponent face the opposition from other interests affected. Lobbying groups will find it more difficult to exploit the budget for particular interests, as expenditures are more carefully traded against tax costs. In this sense, the top-down procedure helps to solve the prisoners' dilemma.

The comprehensive character of the expenditure ceiling is important. Subjecting entitlement appropriations and tax expenditures to the same sort of restrictions as other expenditure categories helps to maintain a permanent discussion on trade-offs across the board.

Every individual, whether a voter, a member of parliament, or a minister, has preferences concerning both his or her individual welfare and society at large. A decision procedure that clarifies the consequences of budget proposals more clearly and confronts them with a common budget restriction can be expected to alter the balance between individual and societal preferences to the benefit of the latter. But it must be clear that there is no neutral reference solution against which various institutional alternatives can be benchmarked. In the absence corrective mechanisms, collective decision-making will be biased in the opposite direction.

A multi-annual expenditure ceiling expands the *time horizon* and forces decision-makers to develop intertemporal trade-offs, if only for the next three or four years. Future interests are better defended when long-term effects of public decisions are visualised. The *demos* is extended, as it were.

It should be stressed that the restraints generated by this mechanism are different from Maastricht criteria or Gramm-Rudman-Hollings type restrictions, which were experienced more as constraints imposed from outside (quite apart from the constitutional problems associated with such solutions; see Eule 1987).

The average MP will feel more solidarity towards an expenditure ceiling that she has voted herself than towards a budget constraint voted a long time ago, perhaps by a totally different assembly (as in the case of the Maastricht treaty). Even if the expenditure ceiling overlaps more than one electoral period (as it will half of the time), there is substantial continuity between successive parliamentary assemblies. This form of constraints therefore comes closer to self-binding in the true sense.

An important determinant of legitimacy is the way in which the expenditure ceiling is computed. Absent a truly interactive process between expenditure forecasts, revenue forecasts and fiscal policy constraints, loyalty to the ceiling will be at best uncertain. Starting from expenditure forecasts at the level of single appropriations, a forecast for the aggregate expenditure level should be matched with a revenue forecast. If the resulting fiscal balance is compatible with previously formulated policy goals (deficit, debt, etc.), no modification is necessary. Otherwise, expenditures will have to be cut, or revenues raised, or both. An iterative procedure must be continued until the fiscal policy restrictions are met. In this way, decision-makers will learn about the relation between aggregate targets and single expenditure systems, and will find it easier to defend difficult decisions.

When discussing the effects of a more stringent budget process on the handling of uncertainty in public decision-making, it may be helpful to draw upon the theory of rationality. The concept of rationality may be given a “thin” and a “thick” interpretation (Elster 1983). The first interpretation, which borders on the tautological (Sen 1982), is more or less equivalent to consistency or stability of preferences. It pays little or no attention to how individual preferences are formed, nor whether they are based on realistic descriptions of the outside world. By contrast, “thick” rationality requires that there be a sound factual basis for preference formation, and that assertions about the outside world be judged against an established yardstick that is reasonably stable.

At the collective level, a similar distinction may be drawn between alternative concepts of democracy. A thin theory of democracy limits attention to the mechanisms whereby individual preferences are merged into collective decisions,

ignoring the phases of preference formation, deliberation, and debate before the collective decision takes place. Such a theory can be criticised on both substantive and procedural grounds; a theory that imposes restrictions also on pre-decision phases of the democratic process represents a more mature state of democratic thinking.

Deliberation plays a central role in a developed theory of democracy. It affects the individual at all levels – by drawing attention to new or neglected facts, fostering empathy with other groups in society, and affecting valuations. There are of course limits to what a deliberative process can achieve in the direction of establishing consensus; at bottom, there are conflicts of interest that cannot be talked away (see various contributions to Elster (ed.) 1998). On the other hand, the deliberative process helps to give these conflicts their right proportions, to identify common interests and to raise the general level of knowledge in the public debate. There is again an interesting analogy between the build-up of knowledge within the scientific community and the role of the deliberative process in the agora of politics. Just as the rules of scientific inquiry helps to create a community that is more objective than the individual scientist (Popper 1972), political deliberation contributes to a society that is more democratic than its individual members.

It is obvious that a budgetary procedure based on a top-down approach, an extended time horizon, and generally increased transparency, strengthens the deliberative element of the decision-making process. Irrespectively of the way preferences are aggregated once they have been formed, they will be better founded than under a conventional procedure.

The *principal-agent* problematique threatens to lead to democratic deficits wherever it appears. Measures taken to cope with such problems – a clear division of responsibilities, improved information, strengthened accountability – will consequently walk hand-in-hand with attempts to strengthen the democratic system.

The responsibilities as such for the main categories – members of parliament, cabinet members, and administration – are not significantly affected by the

transition to a stricter budget process. But the creation of a budget act clarifies the relations in the financial field for one important link in this chain – between parliament and government.

The general stress laid on increased transparency has both direct and indirect effects on democratic aspects of the budget process. Improved in-year and *ex post* reporting helps citizens and mass media to scrutinise the behaviour of their representatives in parliament. Performance indicators adapted to the needs of MP's rather than to the internal needs of the agencies similarly aid politicians in keeping them informed about the ultimate effects of parliamentary decisions.

Constitutionalism

The classical conflict between majority rule and constitutionalism is present also in the fiscal policy area. Budgetary rules define restrictions on the use of political power. The primary gains to be expected from such self-imposed restrictions are a more stable political environment, increased transparency, and more efficient handling of public resources. But to the extent that there is an effect on the way in which preferences are aggregated, it is indirect. Political decisions will be based on more conscious trade-offs between the costs and gains of public undertakings.

A *prisoners'-dilemma* or common-pool problem of constitutional dimensions may arise when a political bloc to the left or the right for strategic reasons imposes its own policy on future governments. Both the left and the right may have problems with fiscal balance – the left because of high expenditures, the right because of low taxes. A government that expects to lose an approaching election may try to limit the freedom of action of future governments by making long-term commitments on the expenditure side or accumulating a large debt, respectively (Persson & Svensson 1989). There is empirical evidence that this mechanism leaves significant traces on the fiscal balance (Pettersson 2000). Such strategic behaviour leads to suboptimal policies of taxation, but it is difficult for an electorate to protect itself against such behaviour. To the extent that a strict budget

process contributes to alerting the public to imbalances, whatever their origin may be, the effect is of course salutary.

To a considerable extent, the tension between majority rule and constitutionalism is a conflict over *time horizons*. The current majority gains from freedom of action in the short run, as it can go ahead with policy changes unhampered by fiscal policy meta-rules. In the medium to long run, such freedom of action may strike back, in the form of public deficits and soaring debts that drastically limit the freedom action of future governments. Given the uncertainty about who will be in power in the future, there is a risk that the trade-off between current and future cost and benefits will be biased. Rules that guarantee some inertia may alleviate the time consistency problem of government (Kydlund & Prescott 1977), but it cannot be eliminated. The trade-off between stability and direct influence for the current majority over fiscal policy is always present.

On the expenditure side of the budget, general values associated with a constitutional regime – stability and predictability of public policy-making – are important. Because publicly administered systems – service production as well as transfers – play such an important role in the life of the citizen, particularly in modern extensive welfare state regimes, a reasonable level of stability is crucial to economic planning at the individual level.

Expenditure cuts caused by a self-imposed requirement to respect the budgetary restrictions of an expenditure ceiling would seem to be a step towards increased instability and less reliable public systems. This short-term effect must be weighed against long-term gains, however – increased financial stability of central government and a drastically reduced risk of financial failure at the aggregate level. Severe crises of the kind experienced by a number of OECD countries during the 1980's and 1990's are certainly more disruptive to the household economy than limited modifications of social benefits or postponed public investments during periods of relative economic prosperity.

A reform in the direction of a stricter budget process strengthens the constitutional aspect of the fiscal policy regulatory framework. By collecting the basic rules and

regulations into a budget act, parliament has made it more likely that government decisions on various issues are based on principles rather than discretion. This contributes to cohesion and consistency and guarantees some equality before the law among physical as well as legal personalities. Nonetheless, it should be recognised that the risk of discretionary decision-making cannot be eliminated (Dahlberg & Johansson 1999). Any budget process framework will have to be flexible enough to allow for such deviations from rule-based decision-making properly speaking.

Efficiency

The efficiency dimension, as mentioned above, concerns both the decision-making procedures in parliament and the implementation phase. There is no question that the top-down procedure introduced in parliament makes the decision-making procedure *internally* more efficient in an overall sense, for reasons given earlier. Theoretically, instabilities within given budget frames can occur, but they are less likely due to the restraining mechanisms described above, and financially less disruptive should they occur.

The same conclusion can be drawn concerning external efficiency of the budgetary process. The most natural direct measure of efficiency would be the risk of serious fiscal imbalances with ensuing high expenditures for interest on government debt, intergenerational transfers, etc. As indicated by von Hagen's index, there is a strong connection between a strict budget process and external efficiency in this sense. But also the mechanism whereby minority governments have a higher probability of seeing their budget proposals accepted by parliament contributes indirectly to financial stability (Roubini & Sachs, op. cit.).

As explained above, a stricter budget process helps to maintain efficient solutions in *prisoners'-dilemma* type situations. This holds both for the short run (annual budget decisions) and the medium to long run (strategic fiscal policy behaviour). The result is increased socio-economic efficiency, although the gains are difficult to quantify.

The large, in some cases uncontrolled, accumulation of debt in a number of OECD countries during the 1980's and 1990's were disruptive and brought substantial welfare losses to the populations affected. Depending on for instance macroeconomic shocks or demographic change, there are sometimes good reasons to run a public deficit, but it is important that such a policy be a controlled response to such exogenous factors. Medium-term fiscal targets and more generally a strict budget process substantially reduce the risk of unplanned debt accumulation.

As indicated in §1, a top-down budget process at least in theory may lead to a higher expenditure level than a bottom-up procedure. This is not in itself a problem; the goal is not to accomplish the lowest possible expenditure level compatible with the ensemble of MP preferences but to correct for in-built biases and achieve as true as possible a picture of the electorate's demand for public services. A process that aims at increased transparency and provokes discussion about costs and gains associated with public undertakings should imply a step forward in this respect.

Again it must be stressed that the way budgetary restrictions are designed and parameters are set is crucial. Without proper concern for effects at the level of single appropriations, there is a risk that macro restrictions are used to conceal rather than highlight such effects.

Efficiency in the principal-agent related sense increases if transparency increases or feedback (accountability) mechanisms are strengthened. Whereas the former of these two aspects is more or less automatically taken care of by a strengthening of the budgetary process, the latter can easily remain a problem. The division of responsibilities within the public sector is unclear in several respects, and mechanisms of accountability are generally weak, for a number of reasons that go beyond the scope of the present discussion (see Lindbeck et al. 2000 for a discussion of the Swedish scene).

Whether cost efficiency in a narrow sense is increased when the budget process is strengthened is a different question. More stringent budgetary restrictions, monthly reporting requirements and an urgent need for better expenditure forecasts would support such a conclusion, but it is yet too early to draw any definite conclusions on this aspect.

4 Conclusions

The relationship between the central government process and democratic ideals is a complex one. Not only are the effects of a process change multi-faceted, but an evaluation has to take into account that a democratic system is intended to serve several purposes, and that the goals associated with these purposes are partly conflicting. The analysis presented is based on a modified rational-actor perspective that permits to describe in some detail the effects of change of regime.

The instrument of evaluation used is intended to capture the degree of popular influence, rule of law, and efficiency of public decision-making. In all three respects, stricter budgetary procedures of the type presented appear superior to the alternative, provided that they are properly designed. Two conclusions in particular deserve emphasis. First, when tackling the ubiquitous prisoners'-dilemma, creating an institutional environment conducive to internalised norms and self-binding promises to yield more lasting results than externally imposed constraints. There is a substantial difference between Maastricht constraints or restrictions of the Gramm-Rudman-Hollings type on the one hand and a self-imposed expenditure ceiling on the other. Second, when evaluating the effects on the democratic system, the deliberative character of the public decision-making system is particularly important. Absent such a perspective, the risk of erroneous conclusions is imminent.

The positive message is that greater fiscal discipline appears not to be achieved necessarily at the expense of democratic values. On the other hand, a number of problems in the fiscal policy area, mainly in the area of accountability, are not automatically solved by the transition to a stricter budget process.

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Captions

Diagram 1. Swedish public sector financial balance in relation to GDP (1980-2001) (Source: Statistics Sweden; projections for 2000 and 2001 by the National Institute of Economic Research)

Diagram 2. Structural indices for the budget processes of the twelve EC countries and Sweden in 1992. Source: von Hagen (1992), Molander (1992b).

Diagram 3. Post-reform structural index for Sweden in 1996 compared to other EC countries. Other countries have not been updated. Source: Molander (1999).

Diagram 4. Swedish public expenditures in relation to GDP (1980-2001) (Source: Statistics Sweden; projections for 2000 and 2001 by the National Institute of Economic Research)