Fiscal Policy Institutions and Economic Transition in North Africa

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Abstract

Sound public finances are crucial for ensuring a successful transformation of transition countries to democratic market economies. The transition countries in North Africa are an important example for this. These countries experienced increasing budget deficits in 2011 and 2012. Public finances will probably remain a serious issue in the coming years due to political uncertainties, distributional struggles and weak world economic growth. What kind of institutional rules for the budget process are suitable to limiting the size of these potential budget deficits in a new democracy? In this paper, I argue that numerical fiscal restraints are not the right tool to reduce budget deficits in a new and fragile democracy. Instead, I hold the view that a strong finance minister and a transparent budget process are much more important than numerical fiscal rules. Assigning prerogatives to the finance minister allows limiting the political deficit bias that may arise due to distributional struggles over government spending and revenue. History has shown that numerical policy rules on their own do not lead to desirable outcomes if they are not supported and embedded by the main political parties. If there are weak institutions, fiscal policy rules might even have a perverse effect when politicians – in trying to comply with the rules – use optimistic forecasts and creative accounting, which would lead to a deterioration of the actual budget situation. Therefore, transition countries should first focus on improving the transparency and accountability of the budget process.

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1. Introduction

After the revolutionary political changes in several countries in the Middle East and North Africa (MENA), the political authorities face the challenge of managing a transformation towards stable and democratic countries with strong economies. The success of such a transformation crucially hinges on institutional arrangements. In this paper, I am going to analyze one important institutional element, namely the rules governing the process of budget formulation and implementation. I draw lessons from the existing literature on budget rules and institutions and draw lessons from it, especially for the transition countries in the MENA region. The focus is on Egypt and Tunisia, although several other countries like Jordan, Lebanon and Morocco face similar political and economic challenges. While countries in this region are not a homogenous group, they nevertheless share important characteristics such as high youth unemployment, a relatively high degree of inequality and a lack of international economic competitiveness.

Sound public finances are a crucial element in ensuring a successful transformation of Egypt and Tunisia to democratic market economies. These countries struggle with high budget deficits and a downgrading of their sovereign ratings, whereby Egypt ranks worse than Tunisia with respect to most fiscal and economic variables. The state of public finances will probably remain a serious issue in the coming years. The people in the new democracies of North Africa naturally expect that economic inequality will be reduced and public infrastructure improved. These countries also have to balance the interests of political groups and religions. Although elections in Egypt and Tunisia have in each country brought about victories for one big political movement, the cooperation between various interest groups is likely to remain fragile for the foreseeable future. All these factors may contribute to large budget deficits and eventually a debt crisis in these countries.

What kind of institutional rules for the budget process and implementation are suitable to reduce this potential deficit bias? In this paper, I argue that numerical fiscal restraints are not the right tool to reduce budget deficits in a new and fragile democracy. Instead, I hold the view that a strong finance minister and a transparent budget process are much more important than numerical fiscal rules. History has shown that fiscal policy rules on their own often do not lead to desirable outcomes if they are not supported and embedded by the main political parties. If there are weak institutions and corruption, fiscal policy rules might even have a perverse effect when politicians – in trying to comply with the rules – increase creative accounting, which makes the budget process less transparent and will thus lead to a deterioration of the budget situation in the longer-run.

The paper is organized as follows. Section 2 gives a short analysis of fiscal policy challenges for countries in the Middle East and North Africa. In section 3, I provide an overview of the literature on the political economy of fiscal policy and try to identify the information relevant for countries in the

MENA region. In section 4, I present a small model to illustrate the arguments made in this paper. This is followed by section 5 that summarizes these findings and gives recommendations for the design of fiscal policy institutions in this region. Finally, section 5 contains the conclusion.

2. Fiscal Policy Challenges for Transition Countries: the Case of the New Democracies in the Middle East and North Africa

The political and economic transformation taking place in the new democracies of the MENA region entails a vast rebuilding of the state system and a strengthening of the private sectors in the economy (see e.g. Amin et al. (2012) for a useful overview). Regarding fiscal policy, the transition to a democracy involves considerable challenges regarding the budget process, as fiscal policy decisions will be discussed more openly among the respective interest groups. A functioning budget process is important for these countries because in 2011 and 2012, the budget deficits in Egypt and Tunisia increased considerably. Both countries face considerable challenges regarding the allocation of government spending and revenue (see Achy (2011) and Amin et al. (2012)). Many advisors suggest that the governments should move from large scale subsidies and transfers to well-targeted social assistance for those who need it the most. At the same time, however, there will be increased demand for social assistance, as people expect economic inequality to be reduced and public infrastructure improved. If a government wants to meet these demands, it will have to increase its expenditures on infrastructure, education, and health. For example, many observers advocate a reform of the education system in order to adequately prepare young people for jobs in the private sector and for democratic citizenship (see e.g. Faour and Muasher (2011)).

The fiscal challenges regarding the composition of government spending and revenue and the associated distributional struggles might worsen public finances. Policy-makers may not possess enough authority to ensure sound public finances. For instance, the perception of the quality of government institutions is low, whereby Tunisia ranks better than Egypt (Kaufmann et al. (2009)). Therefore, governments may not enjoy enough credibility to commit itself to their policies. As a result, the new governments in Egypt and Tunisia face the challenge of building a better reputation and greater credibility, which will be in particular important to ensure sound public finances.

However, a successful transition of Egypt and Tunisia towards democratic market economies will crucially depend on the ability of these countries to limit public deficits. The political and economic transition is unfolding in a situation where world economic growth is decreasing and the political uncertainties tend to deter foreign investors. As a result of these circumstances, economic growth declined and unemployment rates rose in 2011 with signs of improvement in 2012. This led to a decrease in tax revenues and an increase in government spending on wages and subsidies for food and fuel (see Amin (2012)). In 2011, public finances deteriorated and the sovereign ratings of these countries were downgraded, whereby the situation is more worrisome in Egypt than in Tunisia. Government borrowing needs are likely to remain high because of weak economic performance, high fuel prices, and the impact of increases in subsidies and wages in order to respond to social pressures. Because of the difficulties in borrowing from international financial markets, governments borrow more from domestic banks, which tends to crowd out private access to finance.

This impacts negatively on economic growth, because the difficulties in the access to finance in combination with political uncertainties are hampering private investment in both Egypt and Tunisia. This applies primarily to Egypt and to a lesser extent to Tunisia. Attracting foreign investments is difficult because foreign investors might be reluctant to invest heavily in Egypt and Tunisia as long as political uncertainties are present.

Both Egypt and Tunisia have made first steps and reform proposals in order to deal with their medium-term fiscal challenges. Priorities have been mainly detected in a reform of the tax system, the public pension system, a better control of the government wage bill and a better targeted subsidy system. If the political and economic situation stabilizes, more comprehensive reform measures can be expected to be taken in the future. However, important uncertainties remain. Efforts to reduce the budget deficit have heavily relied on tax increases without convincingly tackling the underlying problems of tax evasion and corruption. Government spending reductions have not been appropriately considered yet. In both countries, the constitutional drafts and texts contain a provision according to which the budget amendments of the parliament are not allowed to lead to higher budget deficits[2]. However, these provisions are formulated in a rather general manner and leave some room for interpretation. In addition, there are no provisions that define the role of the finance minister vis-à-vis spending ministers. In the Egyptian constitution, one can also find measures aimed at increasing the transparency of the budget: the final budget is put to vote on a chapter-by-chapter basis and representatives may ask for additional pieces of information. However, many provisions in the Egyptian constitution explicitly call for the law to define matters more precisely, so that the legal process in the future will mainly determine how the budget process evolves.

[2] The constitution in Egypt was approved in the end of 2012, but (temporarily) suspended in 2013. It contains the following provision in Article 116 (unofficial translation provided by "The International Institute for Democracy and Electoral Assistance", www.idea.int): "*The Council of Representatives may modify the expenditures in the draft budget law, except those proposed to honor a specific liability. Should the modification result in an increase in total expenditure, the Council of Representatives agrees with the government on means to secure revenue resources to achieve a balance between revenues and expenditures.* " A very similar provision can already be found in the previous Egyptian constitution in effect before the Arab spring. The draft version of the Tunisian constitution also contains a very similar provision to the one in the Egyptian constitution.

3. The Political Economy of Fiscal Policy and its Importance for the Transition Countries

While the last section focused on the current economic situation in the transition countries and the challenges for fiscal policy, this section discusses the political economy literature on fiscal policy and extracts relevant findings for Egypt and Tunisia. First, I explain why a political bias for budget deficits may appear. Second, I discuss institutional measures that may be taken to lessen this bias. Throughout this section, I provide observations relevant for the transition countries that emerge from the political economy literature on fiscal policy.

3.1 The Political Economy of Budget Deficits

When drafting a budget, policy-makers have to take two kinds of decisions simultaneously. First, policy-makers must determine the level of the budget and, related to this, the aggregates of revenue and spending. Second, a government has to decide on how to allocate government spending and the tax burden. Since there are always political pressures to increase spending and reduce taxes, a political deficit bias may easily appear. Research on the political economy of budget deficits emerged because of persistent government deficits in OECD countries (see e.g. Alesina et al. (1997), Drazen (2000) and Hallerberg et al. (2009) for useful overviews). These models have also been adapted to explain budget deficits in developing and transition economies. Most theories in the political economy of public finances can be related to two general kinds of explanation for budget deficits: the common-pool problem and electoral short-sightedness.

The common pool problem refers to the fact that in the political decision making process, different political groups such as coalition partners, parliamentary opposition or interest groups seek to influence budgetary decisions. The distributional struggle among interest groups emerges because general tax funds are used to finance specific policies, which may lead to persistent budget deficits (Kontopoulos and Perotti (1999) and Velasco (1999)).

Observation 1: *Egypt and Tunisia both show considerable inequalities across individuals, generations and regions. There are therefore a number of different interest groups with divergent interests, which worsens the common pool problem.*

Electoral short-sightedness mainly relates to opportunistic and partisan behavior. Opportunism of politicians to please voters can be used to explain loose fiscal policy, especially before elections. In these models, an incumbent government artificially stimulates the economy by adopting loose fiscal or monetary policies in order to gain popularity and win elections. Several authors (see e.g. Alesina et al. (1997)) have found empirical evidence for opportunistic behavior in fiscal policy, especially in transfers. Brender and Drazen (2005) find that the political budget cycle is mostly visible in new democracies. Models of opportunistic behavior do not consider any differences between politicians when trying to explain a political deficit bias. But in reality, policy-makers wish not only to be reelected, but also to implement the policies desired by their partisans. Partisan fiscal policy of a government results in an increase in spending or a reduction of taxes for its partisans. When such measures are targeted towards a well-organized group, it may be more difficult to reverse them than in the case of opportunistic policies. Structural reforms of transfer and subsidy payments may also be delayed because of the opposition of the partisans. Persistent budget deficits are a likely result of this. An incumbent government may try to benefit its partisans by using fiscal variables such as transfers. In addition, both the ruling party and the opposition are prone to announce tax cuts or spending increases which would come into effect after the election. After the election, the politicians will be under pressure to implement at least some of these promised measures.

Observation 2: *Political movements in the democratic transition countries of Egypt and Tunisia cannot yet rely on stable political support, which will induce politicians to attract voters by increasing spending or reducing taxes for opportunistic or partisan reasons. If this occurs, persistent budget deficits will emerge. The delays in reforming the subsidy systems in both Egypt and Tunisia are examples of this.*

3.2 How to Reduce a Political Deficit Bias? – Numerical Rules or Reforming the Budget Process?

The last subsection discussed reasons for the political deficit bias. This subsection now focuses on ways to reduce this political deficit bias with the intention of applying the findings to the transition countries in North Africa. First, one can focus on reforming the decision process and transparency of fiscal policy in order to reduce deficits. Second, one may implement numerical fiscal rules in an attempt to constrain deficits. Naturally, it is possible to take a combination of these measures, which has been done in several countries by adopting so-called fiscal responsibility frameworks (see Kopits and Symanski (1998) and Kopits (2004)). However, as I argue in this section, having transparent procedures and a respected finance minister with strong prerogatives are a precondition for the implementation of fiscal policy rules.

3.2.1 The Structure and Transparency of Budget Processes

Budget procedures encompass the formal and informal rules governing the drafting of the budget by the executive, its passage through the legislature, and its implementation by the government and the bureaucracy (see Alesina and Perotti (1996)). These procedures distribute strategic influence among the participants in the budget process and regulate the flow of information. In doing so, they have a significant influence on the outcome of budget processes. Therefore, it is natural to ask if some budget procedures are more susceptible to produce a deficit bias than others. Generally, one can group budget processes into hierarchical or collegial procedures (see Alesina and Perotti (1996) and Hallerberg et al. (2009)). "Hierarchical" procedures attribute strong prerogatives to the prime or the finance minister. Hierarchical institutions also limit the capability of the legislature to amend the budget proposal of the government. In contrast, "collegial" procedures limit the prerogatives of the finance minister vis-à-vis spending ministers, or the prerogatives of the government vis-à-vis the legislature.

Under hierarchical procedures, the prime or the finance minister possesses a strong agenda-setting power during the budget planning stage and during budget implementation, especially when it comes to correct deviations from the budget plan. A certain degree of hierarchical power for a finance minister may also develop in an informal way if the finance minister is an independent and competent expert with a strong reputation. In the same manner, an incompetent or opportunistic finance minister may not be able to exercise his formal power entirely or he may use his power to implement sub-optimal decisions. An important feature of a hierarchical budget process is that the legislature can only make budget amendments under the condition that the overall budget surplus or deficit proposed by the executive is unchanged. However, these procedural constraints can only contribute to fiscal discipline if they are not circumvented by direct negotiations between the government and members of parliament.

If, however, budget decisions are made under a collegial system, the different partners regularly meet in order to come to an agreement over budget decisions. The involved ministers or groups start the budget process by negotiating and agreeing on a set of key targets concerning the budget. Once an agreement is found, the minister of finance mainly has the function of monitoring and enforcing the implementation of budget decisions, but he is given little discretionary power. Under a collegial system, amendments to an initial proposal are naturally more common than under a hierarchical system, and different interest groups may have more possibilities to influence budgetary decisions. This can lead to distributional struggles and delayed fiscal adjustments. Collegial systems are therefore more appropriate when the main political parties share common interests and goals regarding the structure of the budget, i.e. the allocation of spending and revenue. If such a consensus exists, involving all relevant interest groups in the decision-making process can improve the quality of political decisions (see e.g. Feld and Kirchgässner (1999)). If oppositional groups are entirely excluded from the budget process and the related political decisions, the opposition might try instead to mobilize the public and, thereby, bring about social unrest.

Since budget procedures vary considerably across countries, they might be useful in explaining the cross-country differences in fiscal performance. However, it is difficult to assess a country's budget procedure numerically, which makes economic studies difficult to conduct. Various historical, judicial and other aspects should be considered (see e.g. Alesina and Perotti, 1996). Hallerberg et al. (2009) provide empirical analyses of the effects of budget procedures. These empirical findings show that countries with more hierarchical procedures tend to achieve more fiscal discipline. In particular, they run lower deficits during recessions because fiscal adjustments are less likely to be delayed.

Observation 3: *Egypt and Tunisia will see serious discussions concerning the allocation of spending and revenue in the coming years. In addition, the political landscape is likely to remain fragmented and unstable. This increases the probability that fiscal adjustments are delayed. A strong finance minister helps prevent the compositional struggle from worsening the overall stance of fiscal policy. To include the relevant political parties in the process, the legislature should still have considerable amendment power, but under the condition that the overall fiscal balance is not changed*[3].

When discussing budget procedures, transparency is a critical issue (see e.g. Kopits and Symansky (1998)). Having transparent budget figures and procedures is important, because policy-makers have a lot of freedom in tailoring budgets. As stressed by Milesi-Ferretti (2004), the less transparent budget processes and figures are, the more policy-makers are tempted to use tricks to adjust budget figures. First, governments may be tempted to publish optimistic predictions for macroeconomic variables in order to make the budget look better. Under low transparency of budget procedures, a government is not required to justify these forecasts. At the end of the year, the "unexpected" deficit can then be attributed to "unforeseeable" circumstances. Second, policymakers are prone to over- or underestimate

[3] Such provisions are in the current constitutional texts, but they are not strongly formulated.

the effects of various new policies on the budget. Third, politicians can make strategic use of what is kept in or off the budget. This includes various techniques to make the budget look better than it actually does by, for instance, selling state assets. Not surprisingly, as found by Bernoth and Wolff (2008), creative accounting lowers confidence in the government and increases bond yields.

There are several measures that can improve the transparency of budget procedures. Budget documents and forecasts including the underlying assumptions should be provided to the public. Such documents could, for instance, be fiscal strategy statements or regular reports on the fiscal outlook. One measure that has been increasingly adopted by various countries in order to improve transparency is to set up a board of independent experts which has the capability and competence to evaluate budget documents and produce forecasts for budget variables (see Calmfors and Wren-Lewis (2011)). Such a strategy is inspired by the assignment of monetary policy to an independent central bank. However, such institutional settings can only work if the quality of public institutions is high. Accordingly, the transparency of budget figures and processes is strongly related to the quality of public institutions. Improving the quality of public institutions goes hand in hand with greater transparency and credibility of a government.

Observation 4*: As discussed in section 2, the quality and transparency of public institutions is perceived to be relatively low in the transition countries in North Africa. To make democratic budget processes work in these countries, the credibility of a government has to be improved by making political processes including budget procedures more transparent. This includes a transparent documentation on fiscal accounting and on how budget forecasts are achieved.*

3.2.2 Numerical Fiscal Rules

A numerical fiscal policy rule is a permanent constraint on fiscal policy that is meant to be followed constantly by successive governments (see Kopits and Symanski (1998)). Such rules have become popular in many countries to reduce budget deficits. After having been adopted mainly by several OECD countries, there has also appeared a rising interest from emerging economies to adopt such rules. Numerical fiscal rules set explicit targets for fiscal variables such as the government budget or public debt. Fiscal rules can be adopted at the constitutional level, in a law, or simply by a declaration of intention. Various versions of numerical fiscal rules exist and the most important ones will be discussed in the following (for a comprehensive overview, see IMF (2009)). It will be shown that these rules are currently not a satisfactory instrument for fiscal policy in Egypt and Tunisia.

The simplest rule is to set a limit to the overall budget. In its most basic form, a *balanced budget* is required. Variants of such a rule set a limit to the budget deficit or even require a surplus. A balanced budget requirement easy to understand, but focusing on the overall balance, requires that the budget be frequently amended during both the planning and the execution phases of the budget to react to the latest developments. In addition, such a rule has the drawback that the economic cycle is not taken into account and a government is obliged to implement pro-cyclical fiscal policy measures that hamper the stabilizing aspect of fiscal policy. For these reasons, balanced budget rules have mostly been implemented only at the sub-national level.

Observation 5: *The transition process in an unstable political environment may lead to high volatility in GDP growth rates in the coming years and output growth rates will be difficult to predict. In addition, Egypt and Tunisia should move away from pro-cyclical fiscal policy. Therefore, balanced budget rules are not an appropriate tool for these countries.*

In contrast to balanced budget requirements or deficit limits, a *structural or cyclically adjusted budget rule* tries to remove the cyclical component of the budget. Variants of this rule relate to a structural deficit or surplus limit. One thereby intends to reduce the pro-cyclical fiscal policies that tend to be associated with overall budget rules. The calculation of the cyclical component of a budget is technically demanding. Therefore, the concept of the cyclically adjusted balance is difficult to understand for politicians and the public. In addition, using different estimation techniques may produce significantly different results. The concerns about the accuracy of calculations become even more serious during times of high economic volatility and inflation. Therefore, such a rule can only work if policy-makers and the public hand the technical issues over to independent experts who enjoy credibility.

Observation 6*: Egypt and Tunisia countries are likely to show a considerable degree of economic volatility and changes in the allocation of government revenue and spending in the coming years. This makes the estimation of the cyclically adjusted budget balance very difficult and imprecise. Therefore, a cyclically adjusted budget rule is currently inappropriate for the transition countries.*

Another way to make fiscal rules more flexible is the so-called golden rule of public finances. The golden rule states that a government is only allowed to borrow in order to finance public investment. Thus, the rule relates to the current (often cyclically adjusted) budget, which excludes public investment. There are several reasons for implementing the golden rule. First, excluding public capital formation from the fiscal rule is linked to the idea that public infrastructure increases potential GDP growth rates. Second, if the benefits of public infrastructure accrue in the future, financing these investments by public debt allows shifting the payments to those generations that benefit from the investment. Despite these reasons, the possibility of unlimited borrowing for infrastructure projects lowers the incentives to evaluate the costs and benefits of projects, which could result in inefficiently high spending on infrastructure. In addition, the golden rule favors large infrastructure projects over spending on other important categories such as education and health.

Observation 7: *Promoting public infrastructure is important for the North African transition countries, but they also need to improve education and health care, which are normally not included in the golden rule. In addition, the requirement of a balanced current budget is associated with the same drawbacks as a balanced or cyclically adjusted budget rule. The golden rule is therefore not a useful supplement to budget laws for Egypt and Tunisia.*

A common feature of all these numerical fiscal rules is that, in theory, they well achieve the goal of sound public finances. However, the possibilities to enforce such rules are limited, because the final budget cannot be precisely linked to the government's intention, but is rather also influenced by the economic cycle and other unexpected events. If a fiscal rule is put into a legal form that allows for some kind of legal enforcement, only a government that has clearly and strongly violated the rule will be found guilty by courts. This can be well seen from the decisions of courts in Germany, and from the peer-review process of the Stability and Growth Pact. To make enforcement quasi-automatic and independent of legal considerations, some numerical rules (e.g. in Germany and Switzerland) foresee in principle an automatic correction of missed budget targets in the following years. This can work well under conditions of political stability and a general political commitment to sound public finances.

Due to these limited enforcement possibilities, a fiscal rule should therefore mainly be seen as a codified intention of policy-makers. Compliance with a rule mainly rests within the discretion of policy-makers. They can be expected to abide more often to a rule if the main political parties and the public support the fiscal rule. Such a broad consensus can only emerge when a country's policy-makers enjoy credibility. This becomes more important when considering that fiscal rules are normally silent on the composition of government spending. If, for example, a society is divided over the composition of government spending and revenue, a broad consensus is absent and support for a fiscal rule might be low. Hence, a successful numerical fiscal rule has to become some sort of a social norm (see Fitoussi and Saraceno (2008)). This means that governments follow the fiscal rule even when it is against their own current interest, because the damage to reputation would be too high. The success of a rule therefore crucially hinges on the credibility and perception of good governance in all areas. This includes the credibility of a government to commit to its policy decisions and to implement them consistently over time.

Adopting fiscal rules that are not grounded on a political consensus and public support may encourage creative accounting and off-budget operations. Policymakers may then be tempted to use such tricks in order to circumvent the ordinary constraints of the budget process, while formally complying with a fiscal rule (see Koen and van den Noord (2005), von Hagen and Wolff (2006) and Buti et al. (2009)). A low quality of public institutions provides an environment where creative accounting can be practiced more easily. Therefore, one should increase the transparency of the budget and strengthen government institutions before adopting a numerical fiscal rule.

Observation 8: *As discussed in section 2, the quality of public institutions and the credibility of the government are perceived to be low by the citizens of many MENA countries. These credibility problems are unlikely to vanish quickly. A political commitment to strict numerical rules will therefore suffer from a credibility problem. Moreover, fiscal rules provide no guidance for the big changes in the allocation of government spending and revenue that many experts see as crucial for Egypt and Tunisia.*

4. Budget Institutions for Transition Countries: a Summary

This section summarizes the observations made in section 3 regarding the design of budget processes and rules for transition countries with a focus on Egypt and Tunisia. The discussion in the previous section stressed that both countries could see a political deficit bias due to the common pool problem and electoral short-sightedness (see Observations 1 and 2). Therefore, these countries should adopt appropriate measures to ensure sound public finances. The new constitution in Egypt and the constitutional draft in Tunisia include provisions that limit the possibilities of the parliament to change the budget proposed by the government. However, the constitutions do not effectively constrain the government and especially spending ministers. The aim should not be to strive for a first-best world, because institutional and economic weaknesses will probably persist. As the experiences of several countries in the Eurozone show, fiscal policy arrangements crucially depend on the willingness of the political authorities to implement them in practice, which requires a minimum consensus in a society regarding fiscal policy. Moreover, as the overall fiscal balance is the result of political decisions and is decided within an uncertain environment, the legal enforcement of any constitutional rules regarding fiscal policy is limited.

However, as was discussed in this paper, there are measures that can provide useful support to limit a political deficit bias. The most important measure is to appoint a respected finance minister with strong prerogatives over the spending ministers and the legislature (see Observation 3). The prerogatives of the finance minister need to be put in a legal form. Ideally, a finance minister should get the right to veto certain spending proposals made by other ministers. Such a structure is appropriate to deal with several characteristics of the current situations in Egypt and Tunisia. A respected finance minister may enjoy the credibility that the political system in general cannot produce. In addition, there will probably be distributional struggles between interest groups in both countries that would yield a serious common pool problem (see Observation 1), and policy-makers may be tempted to delay fiscal adjustments and engage in high deficit spending in order to attract voters (see Observations 2). Since the common pool problem tends to result more often in persistent budget deficits under collegial than under hierarchical budget procedures, the finance minister should be assigned strong prerogatives over spending ministers, but the constitution should ensure that the various political interest groups are to some extent included in the budget process (see Observation 3). Involving all relevant interest groups in the political process requires making the budget procedures and figures transparent. This in turn can improve the acceptance of budgetary decisions and increases the credibility of political decisions (see Observation 4).

Since, currently, the transparency of budget procedures and the credibility of public institutions are low, a successful implementation and enforcement of a numerical budget rule is unlikely (Observation 8). Only simple numerical rules that set general guidelines should be adopted. Strict numerical fiscal policy rules only work when the main political interest groups and the public support such rules. The reason for this is that if a politician does not want to comply with a fiscal rule, he will almost always find a way to circumvent it. If a government has low credibility, the public will expect that the government is engaging in creative accounting and will in general not expect a numerical rule to be appropriately implemented.

The Egyptian constitution and the draft version in Tunisia state that the parliaments have to find additional revenue or spending reductions if they increase public expenditures. Because of the reasons given in this paper, other numerical fiscal rules such as a cyclically adjusted budget rule are currently not appropriate for Egypt and Tunisia (see Observations 5, 6 and 7). However, a government could increase transparency and support its commitment for sound public finances by providing estimations for the cyclically adjusted budget.

5. Conclusion

In this paper, I have discussed what kind of budget processes and rules are suitable for transition countries with a focus on Egypt and Tunisia. For both countries, there are challenges on both levels of the budget process, namely the composition of spending and revenue, as well as on the overall balance. The significant need to re-shift government expenditures and revenues may be associated with considerable conflict between several interest groups. It is likely that overall demand for government spending will increase. This might lead to a neglecting of the overall balance, which would entail large budget deficits. A deterioration of the overall budget would in the long-run have severe consequences such as a crowding-out of the private sector, current account deficits, and eventually a public debt and economic crisis.

I find that numerical fiscal restraints are not the right tool to reduce budget deficits in a new and fragile democracy. Before numerical fiscal rules can be implemented, public institutions need to gain credibility among the public and within financial markets. Accordingly, my conclusions are that a strong finance minister and a transparent budget process are much more important than are numerical fiscal rules in ensuring sound public finances.

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