# Should we cut on the executive in order to save the constitutional state?

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# SHOULD WE CUT ON THE EXECUTIVE IN ORDER TO SAVE THE CONSTITUTIONAL STATE?

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**Abstract**

Constitutional states, as a separate category of social structures, are progressively losing their economic power, as measured with their capacity to appropriate the available capital stock. Fiscal policies, and the corresponding institutions of public finance, play a significant role in the public appropriation of capital, both through direct redistribution and indirect incentives to private allocation. Policies evolve into institutions after experimentation, yet, as a species, we are not really good at experimenting with our own social structures. The case of New Zealand and their public reforms shows an interesting path, possibly to follow, so as to increase the capacity of experimenting with fiscal policies – and to devise more efficient institutions - through enhanced fiscal prerogatives of the legislative in comparison to the executive.

**Keywords**

institutional economics, political economy, fiscal policy

## I. Introduction

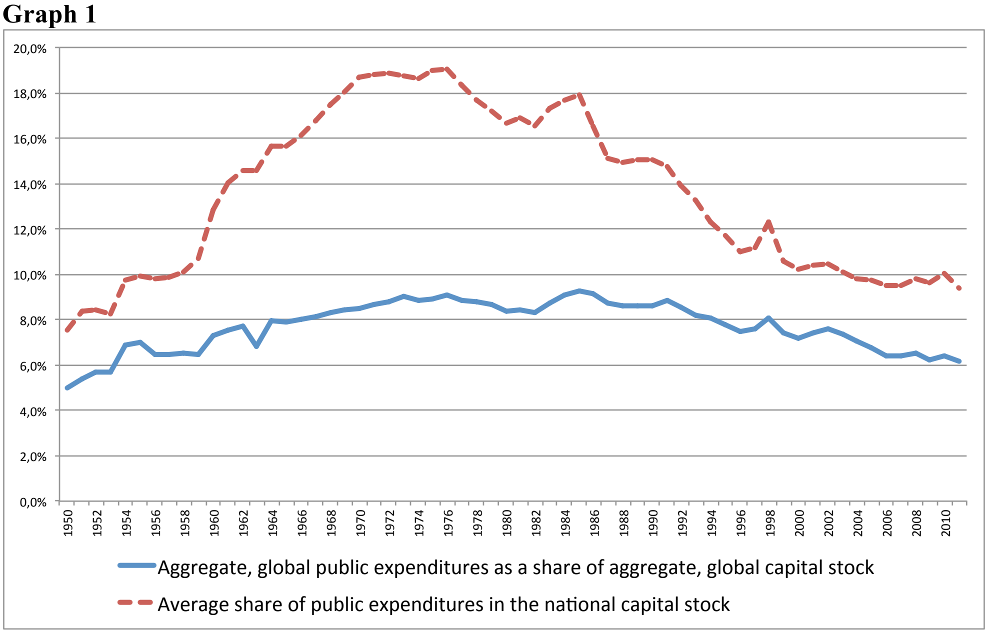
We experience social reality as a set of human interactions, and these interactions display various degrees of recurrence. Those, which are apparently the most recurrent make for us what we call the social structure, i.e. a canvas of predictability that serves us to put some order in all the other social events. For some ten generations, we have been living in a social structure ordered around the constitutional state as central part of the social structure. Everything else – business, politics, law, social activism and many other categories of events – are 'foreign' or 'domestic'. State borders make the neat lines of division in our social space. Yet, it has not always been so. The presently known constitutional state has emerged as the outcome of successive, institutional changes correlated with demographic revivals after major demographic slumps, as well as with big waves of technological change (see for example: Braudel 1981; Braudel 1983). Between 1100 and 1350, the mounting flow of population made the background for the first modern European state: the kingdom of Two Sicilies under Frederick II (1194 – 1250). During those 150 years, a relatively sustainable system of agriculture and food supply developed in Europe, reaching the frontier of capacity around 1350. Significant demographic and economic depression followed, between 1350 and 1450, until a reversal of trend after 1450, when wind power and waterpower were domesticated as the technology of mills. Another leap in the institutional development of the state went along, namely the tripe reign of the 'Three Wise Men': Henry VII Tudor, Louis XI of France, and Ferdinand of Spain. These monarchs created truly modern states, endowed with armies, financial systems and distinct administrative structures. After 1650, until about 1750, Europe experienced still another demographic depression. The modern constitutional, republican state that we know today started to emerge only after 1750, in the company of large – scale industry. Each technological wave, and each period of demographic revival required capital. The state was a major player in its creation and reallocation, just to mention its role as the guarantor of private property rights (see for example: Schlatter 1951).

The available statistical material allows appraising the participation of governments in the allocation of available capital stock (see: Penn Tables 8.1., Feenstra, Inklaar, Timmer 2015). That observation is much shorter in historical perspective than the secular trends mentioned earlier: it starts in 1950. Yet, covering 167 countries, it gives an interesting insight. Graph 1, below, shows the 1950 – 2011 trend in the ratio of public expenditures computed as a share of the capital stock. Two alternative versions are presented: aggregate and distributive average. Both measures seem to be strongly correlated and follow the same trends, with three distinct periods. From 1950 to the mid-1970s, governments appropriate a growing share of the capital stock accumulated. That period roughly corresponds to the widespread tendency to apply Keynesian economic policy in the developed economies. Between the mid-1970s and the mid-1980s, a short saddle is visible: the public sector first recedes, then advances. These are the first years of fashion for monetarism in economic policy. After 1985, when the so-called NCM model of economic governance starts to take root, the trend is clearly descending: the capital stock accumulates much faster than public sectors grow (see: Taylor 2011).

The relative withdrawal of constitutional states from appropriating capital balances can possibly be good news for libertarians or anarchists. Still, from another point of view, something could be deeply wrong with the present design of constitutional states, and maybe we can fix that something. It is to keep in mind that the constitutional state has been, so far, the only type of institutionalized social structure able to enforce human and citizen's rights. Corporate structures don't, because it is not their function. Collaborative structures and local governments can attempt to do so, but they are generally too weak in political terms. The constitutional state, with all its drawbacks, still seems to be a good invention, worth improving.

The decreasing capacity of constitutional states to appropriate capital can come out of two processes. On the one hand, states can lose their economic power as they lose their legitimation to represent key social interests (see for example: Habermas 1975, 1979, 1996; Fraser 1990). Secondly, economic systems may be adjusting, over decades, to the fact that governments tend to distort the marginal efficiency of capital when they appropriate it (see for example: Meade 1958; Modigliani 1961; Diamond 1965).

**Graph 1**




**Source: Penn Tables 8.1., Feenstra, Inklaar and Timmer (2015)**

## II. Experimentation with fiscal institutions – peripheral agencies and autonomy in the legislative

We devise anything new and useful through experimentation. However, whilst we – the humans - are quite good at experimenting and innovating with technologies, we tend to be really conservative about social structures. The Database of Political Institutions, (DPI), as published by the World Bank (Beck et al 2001; Keefer 2012), allows observing that political systems have been becoming increasingly since 1975, i.e. since constitutional states in general stopped to build up their economic position in the social system. On the one hand, that standardization is a sign of progressive, global convergence toward what we call 'democratic standards'. Yet, on the other hand, standardization means less experimentation and less innovative ideas, whilst governance needs innovation just as machines do (see for example: Oates 1972; Tiebout 1956; Francis & Francis 2011; Janeba, 2006; King 2005).

Governments appropriate capital through the institutions of public finance, which find their current expression in fiscal policies. Institutions are based on rules of conduct, which, in turn, are formalized strategies known from actual experience. The emergence and stabilization of institutions in any field of governance, public finance included, can be represented as a game with nature, where the probability of devising optimal institutions over *n* steps in the game is proportional to the number of experiments the players can perform in each step. Assuming that optimal institutions are very much an abstract term, we replace the probability of devising optimal institutions with the quality of institutions, measured as the opposite of distance from the optimal ones. In other words, the more we can experiment with institutions in a unit of time, the better institutions we can create.

The modern constitutional state, which started to form after 1750, is strongly connected to the division of powers, as explained in 'The Spirit of Laws' by Charles de Secondat, Baron de Montesquieu, in 1748. The division between the legislative and the executive is at the heart of fiscal policies, as we know them today. The legislative votes the budget, and the executive uses it. That institutional and political pattern rules the rhythm of public expenditures, taxation, and public borrowing. The basic constitutional pattern of fiscal policy is that of an annual budget, drafted by the executive branch in the government, voted by the legislative, then implemented by the executive, and finally absolved by the legislative. That basic construct is quite slow as for the opportunity to experiment with policies. Most constitutional orders assume functional unity of the budget, i.e. functionally there can be just one budget. Additionally, the full cycle of budgetary planning is, in reality, closer to three fiscal years than to one: usually, budgetary bills are being technically drafted some 9 months before their prospective enactment, on the grounds of preliminary results of implementing the current budget. Summing up, in our experiential game with nature, we have one experiment in each consecutive move, and the move is quite long.

Two types of modifications to that basic pattern, observable in actual, constitutional orders, can be used to overcome that limitation and allow more experimentation with fiscal policies in each consecutive budgetary cycle. On the one hand, it is the institution of peripheral agencies. They carry out specific missions ascribed by specific laws distinct from the budget, and from the regulations of fiscal governance. These laws form the legal basis of their existence. The missions in question usually consist in carrying out long-term tasks connected to large non-wage expenditures. In carrying out these tasks, peripheral agencies have more fiscal autonomy than typical budgetary units: they receive subsidies from the current budget, but these subsidies usually do not make the full financial basis of their expenditures. In the same manner, those agencies can retain their current financial surpluses over many fiscal years. In other words, the financial link of executive agencies with the current fiscal flows is fluid and changing from one budgetary cycle to another. The cycle of capital appropriation in executive agencies is essentially equal to their actual lifecycle as separate units. Peripheral agencies, as an institution of public finance, are widely used in many countries. Still, their presence does not seem to increase the capacity of governments to appropriate capital.

Another institution of public finance that gives more room for fiscal experimentation is a greater autonomy of the legislative branch in drafting and voting budgets. The originality of this pattern is its rarity; it is to observe only in one country: New Zealand. Incidentally, New Zealand is one of the rare countries, where the share of government expenditures in the available capital stock has been growing over the last two decades, and it began to grow precisely after the implementation of public reforms allowing that constitutional pattern.

The entry into force of the New Zealand Public Finance Act 1989 seems to have been a milestone in the process, introducing a novelty at the global scale, namely passing from cash-based budgetary management to the accrual-based one (see for example: Goldman, Brashares 1991). Besides, the New Zealand's fiscal order after the 1989 reform introduced an unusually extensive flexibility of the legislative organs, as opposed to the executive ones, in shaping the current fiscal policy. That flexibility rests on two institutions, namely: the institution of imprest fiscal supplying, and the prerogative to enact fiscal regulations on the own initiative of the legislative, without budgetary bills from the part of the executive. Most constitutional orders contain provisions for provisory fiscal management in case of problems with voting the properly spoken annual budget. Yet, in all those orders (to the author's best knowledge), the attempt to vote the budget comes first, and only after it's failure a financial provisory can be voted for the government. In the New Zealand's fiscal order, the sequence is reversed: first comes the voting of provisory fiscal allocation, in an Imprest Supply Act, and the vote of the Appropriation Act comes later. The Imprest Supply Act plays the same role that the governmental budgetary bill plays in other constitutional systems. Thus, instead of the government having the de facto monopoly to bill fiscal allocations, the New Zealand's Parliament plays that game with itself, so to say. The legislative proposes some fiscal allocation to itself in an Imprest Supply Act, votes it and looks what happens at the executive level, to vote the definitive Appropriation Act in a second step. Interestingly enough, the Public Finance Act 1989 provides neither a unified definition of the Imprest Supply Act, nor of the Appropriation Act. Hence, the legislative can decide quite freely, which strand of the legislative work gives rise to preliminarily supplying public agents with money, on the one hand, and which legislative action leads to definitive budgetary appropriation. **Section 4A** of the Public Finance Act 1989 (last amended in 2004) refers to the authority of the Imprest Supply Act, and states that the authority given by an Imprest Supply Act to incur expenses or capital expenditures in a financial year in advance of appropriation is an authority under an Act. Yet, this provision does not apply unless an appropriation for the expenses or capital expenditure is made before the end of the financial year. **Section 11** introduces the possibility of assigning appropriations under other acts than the appropriation act. Such appropriations are autonomous (they do not require confirmation by or under an Appropriation Act). Thus, the general principle is that allocating appropriations as for responsibility, administration, scope and period of validity is the exclusive prerogative of the legislative. The executive is left with some discretional freedom as for the actual use of appropriations. Still, Section 11 leaves a lot of questions. It technically allows any duly voted Act to provide for payments to be appropriated by public agents. If this principle was applied consistently, the Appropriation Act would be just one among many acts that regulate the spending of public money, and the very institution of statutory, annual budget could *de facto* disappear, whilst leaving the legislative in full control of public expenses. Going further that way, and assuming that being a government requires some real, actual economic power, we can imagine the legislative creating many parallel *de facto* governments for one fiscal year, through parallel voting and implementation of many acts with provisions as for the appropriation of public money. Such a system, unthinkable at the first sight, is even more realistic given the provision of **subsection 11(2)**. The latter states that all appropriations based on duly voted acts have to be managed and accounted for in the same manner, as provided for the main Appropriation Act. Thus, there is a unified system of management and reporting with the possibility of free allocation of public money at the legislative level, very much in the lines of business management in corporate structures.

**Section 12B** gives to the Crown the authority to make capital injections under Imprest Supply Act. The authority given by an Imprest Supply Act to make a capital injection in a financial year in advance of authorization under an Appropriation Act must be treated as an authority under an Appropriation Act, both regarding the current fiscal management and the emergency expenses, as long as the capital injection is subsequently authorized under an Appropriation Act before the end of the financial year.

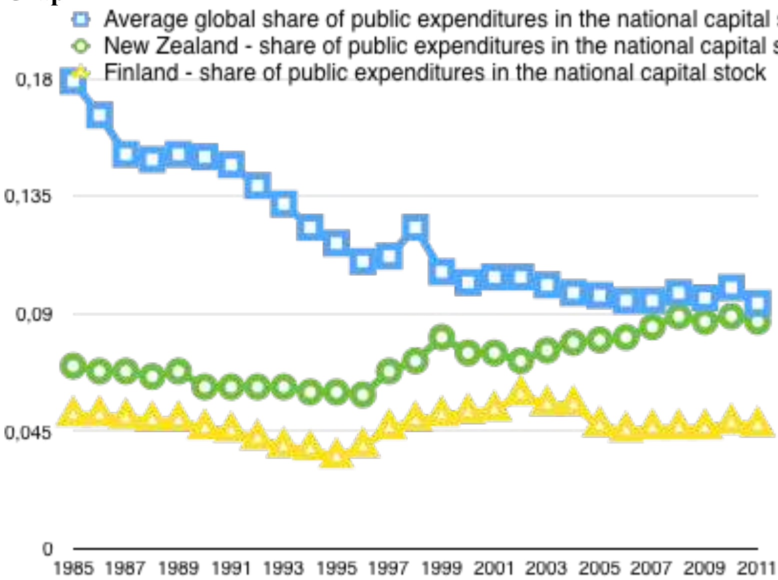
This self-inspired fiscal activity of the Parliament is highly unusual, as compared with other possible regulatory orders. The usual pattern is that of the legislative bodies voting over bills presented by the executive: the executive has the exclusivity to draft bills, and the legislative has the exclusivity to enact them through voting. Although some other institutions can enhance, at least in theory, the relative autonomy of the legislative in fiscal matters, the New Zealand's approach has the peculiarity of having brought significant fiscal change. The role of legislative organs finds an interesting expression in the dual system of financial planning, through the Imprest Supply Act on the one hand, and the Appropriation Act on the other hand.

## III. New Zealand and Finland – the fiscal outcomes of two distinct regimes

In the context of the above it is interesting to compare two countries, New Zealand and Finland, as for the participation of their respective, public expenditures in their national capital stocks. Finland is some kind of fiscal champion at the global scale. Since 1980 through 2012, it maintains a positive fiscal balance, both at the primary, and at the structural level. On the other hand, it combines all the factors of political fragmentation, both constitutional and partisan. Thus, it is a living proof that strongly differentiated political systems can generate high fiscal discipline. Its reserves of public financial assets, combined with a noticeable gross public debt, and a net claim on the rest of the world (negative net debt) call for the metaphor of a bank-country. Besides, Finland has developed a whole structure of public peripheral agencies. They are relatively small, and prudently endowed agencies of the government, in charge of carrying out many innovative projects in the broadly spoken field of economic development. Those agencies are staffed with people coming from many political parties and fractions, and are supposed to bring together the different economic programmes into concrete, specific projects (see for example: Breznitz, Ornston 2013).

Graph 2, below, compares three trends as for the share of public expenditures in the national capital stock: the global distributive average, Finland, and New Zealand. The span of observation starts in 1985, so at the moment when the first timid winds of institutional change started to blow in New Zealand, and, incidentally, in Finland too. One can notice that real divergence starts in 2003, when Finland definitely goes on following the global trend, and New Zealand starts to go definitely against it, with consistently increasing participation of the public sector in the national capital stock. According to the data published by the International Monetary Fund (IMF 2015), the current fiscal stances of both countries (i.e. fiscal balance, public debt etc.) followed the same direction, provided, of course, for different absolute magnitudes of fiscal variables.

**Graph 2**




**Source: Penn Tables 8.1., Feenstra, Inklaar and Timmer (2015)**

Another interesting observation about New Zealand is that at the beginning of public reforms the public sector was quite greedy, holding over 24% of the GDP in liquid financial assets (defined as the differential between the gross, and the net public debt), and recording a significant indebtedness. From 1985 through 1989 (when the Public Finance Act 1989 was voted), the share of public, financial assets in the GDP shrank significantly, and the structural balance improved. It was probably the most immediate result of passing from cash-based budgetary accounting to the accrual based one. That transition probably terminated a lot of small capital pockets held by public agents through the postponement of cash settlements. The spectacular deflation of public financial assets, and the betterment of the structural balance are the most striking fiscal changes accompanying the reforms. Later on, over the next 15 years, public debt decreased significantly both in gross and net terms. Public financial assets inflated again after 2004, just as public debt, not to the previous levels, though. Interestingly enough, private capital aggregates, namely saving and investment had been changing in close correlation with the public ones. In general, 2003 – 2004 seem to be the moment, when fiscal reforms reached some kind of peak in their quantitative outcomes. Thus, when those reforms brought their full benefits, the constitutional state of New Zealand started to regain grounds as for its economic power.

## IV. Conclusion

The present paper attempts to open a path of research focused on the economic power of constitutional state. A specific line of thinking is being sketched, where the central variable to care for is the capacity of constitutional states to appropriate capital through their current fiscal policies. Whilst frown at by liberal economists, that capacity is the very foundation of the actual capacity of constitutional states to do anything else, inclusive of guaranteeing and enforcing individual rights. We can currently observe two interesting processes at the global scale: a progressive withdrawal of constitutional states from the fiscal appropriation of capital stocks, and a tendency to standardize models of public governance. The former means less economic power in the constitutional state. The latter might express a temporary halt in the collective learning of new patterns as for public governance. New Zealand, with its public reforms initiated in 1989, presents an interesting example of a parliamentary democracy, which had enhanced its capacity to experiment with fiscal policies by increasing the budgetary autonomy of the legislative. The constitutional order of New Zealand seems to be the first, and so far the only case of the legislative branch in government being able to bypass the well-known principle of functional unity in the budget. That creates room for fiscal experimentation. In the same time, by shifting the fiscal authority more towards the legislative branch, that institutional pattern allows better representation of various social interests in the fiscal policy. The fiscal performance of New Zealand proves that a flexible legislative can be more efficient a driver of prudent fiscal policies than most known ‘strong governments’.

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