

# Dissertation Outline

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Academic Discipline: Political Science

Dissertation Title: **Finance Ministers in Distress: Testing the Role of Institutional Decentralization in Public Financial Crises**

The thesis is concerned with political and economic institutions and their effect on macroeconomic stability in medium income countries. The focus is on the Latin American and Caribbean countries that share a long history of instable public finances. My thesis offers a new way of thinking about how public financial crises, including notoriously high debt levels and sovereign defaults, are created. Failure to stabilize public finances is analyzed as a “problem of the commons”. Public households in this context are treated as a common-pool-resource. Overusage of the common-pool-resource by various budget actors is a crucial factor in explaining unbalanced public households. It can lead to a range of consecutive problems, including extensive public debt levels and the risk of sovereign default.

Persson and Tabellini provide a widely discussed theoretical framework that describes how institutions affect the size of general government expenditures.<sup>1</sup> The main argument in their model states that decentralization of budgetary institutions leads to weaker control over public finances. This is because decentralization creates incentives for many budget actors to overspend and overborrow. As a large number of political actors on different levels of government draw on the same national tax source the desire to increase overall public spending is likely to grow. Consequently, many countries are caught in a vicious cycle of overspending and overborrowing. In the institutional literature, stronger budget institutions are often found to work against this trend. For example, the creation of a single budget authority with the power to veto budget proposals by different actors is one way to strengthen budget institutions. Introducing new legal controls like spending laws and deficit targets are another.

The thesis aims to test empirically which institutions have lead to improved public finances in the past. In the empirical analysis we test the decentralization-argument with a mix of quantitative and qualitative evidence to offer a Political Economy explanation for fiscal performance. Building on a large literature on budget institutions in OECD countries, the first goal is to test the relevance of existing theories in countries at a significantly lower level of economic development. Are the institutional changes that helped to successfully reduce deficits in the context of the Maastricht-

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<sup>1</sup> Persson, Torsten, and Guido Tabellini 2000. *Political Economics: Explaining Economic Policy*. The MIT Press, Cambridge, MA.

process of the European Union helpful to reduce deficits in Latin American and other medium-income countries? This and related questions will be tackled in cross-country analyses.

Second, the thesis aims to contribute to the literature by applying a novel theoretical framework. It combines two branches of the existing institutional literature - the fiscal federalism literature and the budgetary institutions literature. The combination of both branches of literature allows us to show empirically how both dimensions affect overall fiscal performance. We therefore look at the independent effect of each of the two institutional variables while controlling for potential alternative factors. Next, we look at interaction effects of fiscal federal relations and national level budget institutions. If they do interact this would not only constitute an important new empirical finding. It would also lead to different policy implications.

In addition to statistical analyses the thesis looks at the role of institutions in four detailed case studies. We draw on interviews with 30 experts including former Finance Ministers, Central Bankers, economic policy experts and financial market participants that were carried out in four Latin American countries in 2008 and 2009. This section compares budget institutions in Argentina, Brazil, Ecuador and Uruguay in the past 15 years. With Argentina and Brazil we compare two federal countries which constitute the biggest economies of the region. Additionally, we look at two small unitary countries with comparably small economies, Ecuador and Uruguay, in the same time period.

In different steps of the empirical analysis we try to test our theoretical argument that both dimensions of institutional decentralization – horizontal and vertical – are crucial determinants of fiscal imbalances in medium-income countries. Furthermore, we try to investigate if there is an actual causal mechanism that leads from overly decentralized institutions to extensive public deficits, unsustainable debt levels and eventually to public financial crisis by creating the wrong incentives for budget actors. The empirical analysis aims to provide a better understanding of the interplay between different institutions and budget actors on the national and subnational levels of government.