

Democracies and Deficits: Prospects for Fiscal Responsibility in Democratic Nations

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The financial crisis had significant implications for the fiscal positions of OECD nations. As nations seek to cope with the economic contraction, budget deficits and debt have risen to near record postwar levels. As nations cope with the resulting fiscal imbalances, they will also be dealing with longer term fiscal pressures stemming from the aging of populations and rising health care costs. Unlike previous recessions, the return of strong growth will not end the fiscal gaps facing these nations, but will serve as the prelude for even more difficult and wrenching choices.

The depth of the economic contraction and financial crisis in many European nations highlights the difficult balancing act that nations and the European community itself have to make between short term economic stimulus and fiscal consolidations. Once the recovery begins in earnest, the magnitude of fiscal adjustments faced by nations will only grow the longer they delay implementing consolidation. Nations that procrastinate by waiting for a crisis to provide cover for the politically hard choices will pay a steep price indeed, both economically and politically. A market driven fiscal crisis, while providing cover for democratic leaders, would require major policy changes to be instituted in short order, causing untold political and social dislocation and risks to millions of people. Some nations, like Greece and Portugal, are now paying a steep economic, fiscal and political price for allowing unsustainable fiscal policies to develop and fester. The bond markets are forcing precipitous changes that leaders were reluctant to seek on their own.

The real question is whether democratic nations can take proactive leadership before a crisis forces their hand. Many in the academic and policy community have raised questions about whether advanced democracies have the political wherewithal to respond to gathering fiscal pressures through early and timely action. The democratic political imperative is viewed as being at odds with the fiscal responsibility imperative. It is alleged that political leaders have few incentives to call for fiscal sacrifices, and many reasons to delay or deny. In this view democratic leaders will only take action when a market driven crisis forces their hand. Leaders are advised to insulate themselves behind fiscal rules and delegate hard choices to non-political agencies or commissions to sidestep the inevitable pressures of contemporary democratic systems. The capacity of a democratic system to exercise fiscal self restraint and foresight are among the central questions facing advanced systems today.

Deficit and Debt Position of OECD Member Countries

The legacy of the Great Recession for fiscal policy is staggering. Average national deficits for OECD spiked from 1.2% of GDP in 2007 to a level approaching 8% of GDP in 2010 – after having more than doubled from 2008 and grown nearly six-fold since

2007. Accumulated public debt, it is projected at 95.8% of GDP for the OECD as a whole for 2010 – after having grown by nearly 16.8 percentage points of GDP from 2008 and 22.8 percentage points of GDP since 2007.

For the major regions in the OECD, the deficit situation is most critical in the United States, but the level of accumulated debt in the United States and the Euro area is similar. The deficit figure for Japan lies between the United States and the Euro area, albeit its level of accumulated debt is more than double that of the United States and the Euro area. The following table shows this in more detail.

	2007	2008	2009	2010	2011	2012	2013
United States							
Actual balance	-2.9	-6.6	-11.6	-10.7	-10.0	-9.3	-8.3
Underlying balance	-3.8	-6.3	-8.9	-8.5	-7.9	-7.7	-6.8
Underlying primary balance	-1.8	-4.5	-7.4	-6.8	-6.0	-5.6	-4.5
Gross financial liabilities	62.1	71.4	85.0	94.2	97.6	103.6	108.5
Japan							
Actual balance	-2.4	-2.2	-8.7	-7.8	-8.9	-8.9	-9.5
Underlying balance	-4.4	-4.4	-8.3	-7.7	-8.0	-8.3	-8.6
Underlying primary balance	-3.7	-3.5	-7.2	-6.6	-6.7	-6.8	-6.7
Gross financial liabilities	167.0	174.1	194.1	200.0	211.7	219.1	226.8
Euro area							
Actual balance	-0.7	-2.1	-6.4	-6.3	-4.0	-2.9	-1.9
Underlying balance	-1.8	-2.8	-4.7	-4.1	-2.8	-1.4	-0.4
Underlying primary balance	0.9	-0.1	-2.3	-1.7	-0.3	1.3	2.5
Gross financial liabilities	71.8	77.0	87.6	92.9	95.6	97.9	98.2
OECD							
Actual balance	-1.3	-3.4	-8.3	-7.7	-6.6	-5.9	-5.1
Underlying balance	-2.8	-4.3	-6.8	-6.4	-5.7	-5.0	-4.2
Underlying primary balance	-0.9	-2.5	-5.1	-4.6	-3.8	-2.9	-2.0
Gross financial liabilities	73.3	79.7	91.4	97.9	101.6	105.7	108.4

Source: OECD Economic Outlook 90 database.

Note: Actual balances and liabilities are in percent of nominal GDP. Underlying balances and underlying primary balances are in percent of potential GDP.

The underlying balances are adjusted for the cycle and for one-offs. The underlying primary balance is the underlying balance excluding the impact of the payments

Total OECD actual balance excludes Chile and Mexico.

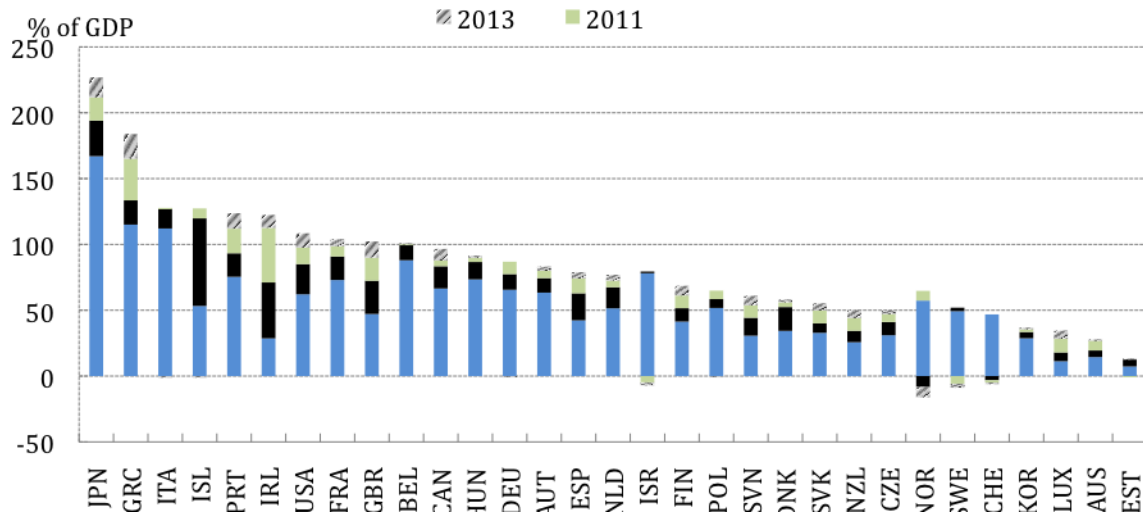
Total OECD underlying balance excludes Chile, Mexico, Slovak Republic and Turkey.

Total OECD underlying primary balance excludes Chile, Mexico, Slovak Republic and Turkey.

Total OECD gross financial liabilities excludes Chile, Mexico, and Turkey.

The following figure shows the evolution of government debt accumulation for individual OECD countries since 2007, *i.e.* how much debt has been added during the crisis. The figure is quite revealing, especially in putting the debt accumulation of specific countries in perspective.

Figure 1. Evolution of Government Debt Accumulation
Per cent of GDP



The debt accumulation has been heavy in the OECD as a whole – but the cases vary greatly. Iceland stands out – by far – as having taken on the greatest increase in debt due to the crisis to be the 4th largest debtor country among OECD Member countries – and this from having had among the lowest levels of debt before the crisis. Ireland and the United Kingdom follow in the accumulation of debt. Countries such as Japan and the United States also experienced significant increases but much lower than the above mentioned countries.

The OECD has calculated a long-term scenario to 2025 the fiscal consolidation requirements needed *to stabilize the level of debt* over a long-term horizon. These calculations are used for comparability purposes only and is in no way meant to reflect the policy options of individual countries. According to these calculations, Japan has the highest fiscal consolidation requirements beyond 2011 followed by Ireland, the United States, and the United Kingdom. (Interestingly, Iceland has a relatively low future fiscal consolidation need due to the strong policy measures already implemented.)

The following table details these calculations for individual countries. (Note that references to “primary balance” refer to the balance before interest on debt outstanding.)

Consolidation Requirement to Stabilize the Debt-to-GDP Ratio over the Long-Term Horizon

As Percent of Potential GDP

	Underlying Primary Balance in 2010 (A)	Underlying Primary Balance Required to Stabilize Debt ^a (B)	Required Change in Underlying Primary Balance (C) = (B) - (A)	Change in Underlying Primary Balance in 2011 (D)	Requirement Beyond 2011 (C) - (D)
Australia	-1.8	0.1	1.9	1.0	0.9
Austria	-0.9	0.9	1.8	0.4	1.4
Belgium	2.0	0.7	-1.3	0.7	-2.0
Canada	-2.4	0.0	2.4	0.2	2.2
Czech Republic	-3.2	-0.3	2.9	0.9	2.0
Denmark	-0.5	0.1	0.6	0.3	0.3
Finland	-0.4	-0.3	0.1	-0.7	0.8
France	-3.3	1.7	5.0	0.7	4.4
Germany	-1.1	1.5	2.7	0.6	2.1
Greece	0.0	2.7	2.7	3.8	-1.1
Hungary	2.4	2.5	0.1	0.0	0.1
Iceland	-2.1	1.7	3.9	3.3	0.6
Ireland	-6.3	2.0	8.3	0.3	8.0
Italy	1.7	3.5	1.8	0.0	1.7
Japan	-5.0	3.9	8.9	-0.3	9.2
Korea	1.0	-4.5	-5.5	-0.3	-5.2
Luxembourg	-2.7	0.0	2.8	-1.2	3.9
The Netherlands	-2.2	0.9	3.1	0.8	2.3
New Zealand	-3.6	0.1	3.7	0.1	3.6
Norway	-3.9	0.5	4.4	0.4	4.0
Poland	-4.8	2.1	6.9	0.3	6.6
Portugal	-4.1	2.2	6.3	1.6	4.6
Slovak Republic	-3.5	1.6	5.1	1.2	3.9
Spain	-5.6	0.8	6.3	1.2	5.1
Sweden	1.8	-0.2	-2.0	1.0	-3.0
Switzerland	0.3	0.0	-0.3	0.1	-0.5
United Kingdom	-5.7	3.1	8.8	0.9	7.9
United States	-7.0	2.4	9.4	1.4	8.0

Source: OECD calculations.

^aUnderlying primary balance required in 2025, based on gradual but steady consolidation paths, to stabilize debt-to-GDP ratios over the long-term horizon, embodied in the long-term baseline scenario presented in OECD Economic Outlook 87. Debt stabilization may take place at undeniably high levels.

Principles for Fiscal Consolidation

Multilateral institutions such as the OECD and the IMF have articulated several principles to guide the process of fiscal consolidation, based partly on lessons learned from previous fiscal consolidation episodes.

The foremost principle is the necessity for countries *to establish a credible deficit reduction plan*. The announcement of a credible plan can lead to a shift in expectations of key economic and financial players. By providing specific expectations and greater certainty about fiscal outcomes, credit markets may lower risk premiums demanded in financing public debt. Such a plan can provide for a phased in approach to accommodate the continuing need to provide fiscal stimulus in the shorter term to be countered by a longer term fiscal consolidation strategy. The most successful plans involve large, multi-year adjustments; in fact, scale can make possible reforms that alone would not be politically feasible. They also should be biased towards spending cuts, rather than revenue enhancements. While appearing as a statement of the obvious, its implementation has proven difficult. For example, an OECD comparison of documents submitted by European governments to the European Commission as part of their medium-term *Stability Programmes* in early 2010 with concrete policy measures announced domestically, revealed that only one-fourth of the measures announced in the *Stability Programmes* were backed by concrete fiscal consolidation measures.

Deficit reduction of this scale is a social project, not a normal budget exercise controlled by budget officials and agencies. Unlike many budget reduction exercises, this kind of multi year plan calls for a more open and inclusive approach involving public engagement and extensive programmatic value for money assessments. Japan has embarked on a series of *public budget hearings* where officials of spending ministries and the Ministry of Finance must defend every aspect of their budget under keen scrutiny of “cross-examiners” consisting of Members of Parliament and academics. The contribution of the hearings to specific deficit reduction actions may be limited, but its overall contribution to establishing public support for fiscal consolidation has been profound. The hearings are streamed and televised and have been among the most watched and talked about events in Japan.

Fiscal rules are a key to underpinning fiscal consolidation efforts. Fiscal rules underpin the political commitment to fiscal discipline. The design of the fiscal rules is however paramount – as the experience with past fiscal rules has shown. The successful experience of countries such as the Netherlands and Sweden that have domestic expenditure-based rules highlight the advantage of coupling deficit and debt reduction rules with spending constraints. Expenditure rules are also simpler to explain to elected officials and citizens, and are more difficult to evade.

The creation of *independent fiscal councils or parliamentary budget offices* reinforces discipline. They serve as an institutional check on using “optimistic” economic forecasts as well as other assumptions underlying the budget. The *Fiscal Council* of Hungary is a primary example of how such a body can restore trust by the public and markets in the government’s commitment to fiscal discipline. Most recently, the United Kingdom has announced the creation of an independent *Office for Budget Responsibility* for the same purpose.

Finally, *the operation of the budget formulation process* is very important for its outcome. Nations have come to realize that an inclusive budget formulation process maximizing opportunities for buy in and ownership of specific budgetary plans by agencies and their clientele are critical for making and sustaining hard choices. During its fiscal crisis in the mid-1990’s, Sweden recognized that the budget process had been a contributing factor and embarked on some of the most far-reaching reforms to the budget formulation process made in any OECD Member country. They focused on introducing top-down budgeting, or “Every Minister is His Own Finance Minister.” This involved political priority setting and allocating the financial envelopes to line ministries at the center and then a very decentralized approach to the final allocations of funds within a given envelope. This operates in conjunction with maximum managerial flexibility being given to line ministries. The good experience with the Swedish approach as repeated by several other countries has made this another key principle for successful fiscal consolidation.

Can Democracies Take Early Action?

The foregoing suggests that leaders in OECD nations face a daunting array of short and long term fiscal challenges. Fiscal gaps are daunting, perhaps more daunting than at any time in postwar history. According to recent IMF data, the world's deficits will remain 3 percentage points larger in 2015 than in 2007 even though output gaps would have been closed. Beyond the short term, the United States and many European nations face the longer term problems of dealing with the unsustainable costs posed by an aging society and rising health care costs.

The question is whether advanced democracies have the political capacity to make the hard fiscal choices early enough to avoid a future featuring serious economic and fiscal shortfalls and precipitous and divisive political choices. Herbert Stein, chair of the Council of Economic Advisers under Presidents Richard Nixon and Gerald Ford, famously said: "If something cannot go on forever, it will stop." But there is a corollary – how it stops matters.

Timely and early action can tame the magnitude of fiscal deficits by intercepting the growth of government interest costs before they crowd out public fiscal flexibility and private markets. In the United States, long term budget models show that the failure to curb fiscal deficits over the next several decades will enable interest costs to become the largest "program" in the budget, exceeding health care and social security. Politically, timely action on fiscal problems can yield significant dividends by providing the public time to make adjustments in their own retirement and savings plans and their expectations about the role of government in their lives.

If nations wait until a market crisis forces their hand, a steep price will be paid for economies and public alike. As we have seen recently in nations like Greece, nations can suddenly be forced by bond markets to make much delayed reforms in major entitlements and tax policies during the trough of a painful recession. While promising eventual economic load shedding, ill-time fiscal consolidations have the potential to be self defeating, prompting a vicious cycle of continued economic decline and short term fiscal erosion.

Other nations have had either outright defaults or serious flirtations with insolvency for which they have paid a long term economic and political price. According to one estimate, more than 90 nations have in fact defaulted on their debt over the past two centuries (Krueger 2010). Many other nations at the financial brink managed to avoid default, but nonetheless experienced economic shocks and policy upheavals that caused rapid erosion of economic wealth and incomes.

The effects of such a shock are wide ranging. Economically, currencies will experience rapid depreciation, ushering in spikes in inflation and interest rates. As the pressure to meet its fiscal commitments increases, some governments might resort to printing more money to lessen the debt burden, creating massive inflation. In either case, economic growth would collapse and the standard of living would decline (Burman, 2010).

Implementing the fiscal cure – spending cuts and tax increases – in the throes of a crisis would cause painful adjustments as well, at least in the near term. Much delayed changes would have to be implemented abruptly with little deliberation or debate. Major changes to entitlements and tax benefits that have become engrained would have to occur almost overnight, as national leaders strain mightily to regain the confidence of credit markets and other investors throughout the world.

Eventually, such actions would probably restore economic growth, tame inflation and cut interest rates, but not after taking incomes and benefits below levels that most of us have come to expect. Early action on fiscal pressures could have mitigated extreme cuts and enable adjustments to be phased in over many years, but an economic and financial crisis no longer affords this luxury. Ultimately, political instability could very well arise in its wake, as painful choices force difficult tradeoffs to be made among mainstream groups and interests. In the past two years alone, governments of Greece, Italy, Portugal, Ireland and Spain have been forced to step down in the throes of economic and fiscal crisis.

Erosion of faith in the political efficacy of democratic institutions

Notwithstanding the overwhelming advantages of early action on fiscal challenges, many observers have come to the conclusion that our system and our leaders are incapable of acting with foresight on long term problems. The conventional view of many of our most sophisticated commentators is that it will take a crisis before we collectively come to grips with the hard choices that need to be made on the spending and tax sides of the budget. In this view, foresight is a politically unnatural act by elected officials who primarily focus on their next election far more than they do the fiscal prospects facing the nation twenty years from now. Drazen and Easterly conclude that the hypothesis that a crisis is necessary to induce significant reform has become the new orthodoxy (Drazen, Easterly, 2001).

In the United States, this dour outlook has been voiced by some of our leading fiscal observers. Leonard Burman, a leading public finance scholar and public official has concluded

“The basic problem is that policymakers want to make people happy, which means more spending and lower taxes. As long as interest rates stay low and the public does not express a strong aversion to deficits, there is little cost to political pandering. Politicians face the same kind of incentive for short-term actions that may be detrimental over the long-term as corporate executives do. Corporate CEOs are rewarded financially for boosting short-term profits, even if they harm the company over the long-term. Political leaders perceive that their reelection depends on short-term results, even if the short-term expedients may be disastrous over the long term” (Burman, 2010).

The perceived conflict between the electoral imperative bearing down on public officials and the fiscal responsibility imperative is not only quite prevalent among policy leaders in the United States, but it has deep academic roots. Public choice theorists have contributed their own theoretical justification. The behavioral assumption behind this view is that public officials are motivated by their self-interest to pursue private gain at the expense of the public interest. Buchanan attempts to demonstrate how bureaucrats and politicians alike will force government budgets to be higher than they should be to increase their own “political incomes” (Buchanan, 1977). Agents use their superior information as well as their superior political organization and intensity over principals, i.e. the electorate, to push up spending and perpetuate a larger public sector. Government is a monopolist and not a neutral responder to demands from public (Mitchell). Buchanan and Tullock argue that politicians are incapable of fixing the deficit. Elections make them shortsighted and irresponsible and only a major crisis will or constitutional amendment will force fiscally responsible actions (Buchanan, Tullock 1962).

Beyond public choice theory, other political scientists have long observed that the common pool problem creates asymmetry between those benefitting from narrow benefits and those paying the costs. As James Wilson has observed, “clientele” politics promotes the expansion of government benefits because those enjoying concentrated benefits have a greater incentive to mobilize than do the broad publics paying for these programs. However, efforts to unwind these programs are undermined by “entrepreneurial politics” where those bearing the concentrated costs of cutbacks have greater incentive to voice their concerns than do broad publics who stand to realize diffuse gains (Wilson, 1980). Many would conclude that this incentive structure would foster deficits and curb efforts to balance budgets because of the bias toward higher spending implied in this asymmetry. This asymmetry of interests is reflected in an asymmetry in mobilization = the most intense interests with the greatest incentives to mobilize are the narrow groups benefitting from higher spending or lower revenues, not the broader publics who have to finance the costs in one way or the other.

The bias against early action on deficits is reinforced by the steep discount rates that political leaders are said to adopt. Political leaders are shortsighted and have even less incentive to promote sacrifice among current taxpayers for the benefit of future taxpayers or public officials. The election cycles are often two to four years in most democracies, reinforcing the short-term bias of elected officials.

In some respects, recent changes in policymaking and budgeting in the United States have reinforced the potential of the system for gridlock and stalemate over major changes. While such a system may be ideal for sustaining a healthy fiscal equilibrium, it is not well suited to produce major reforms requiring agreement among increasingly polarized and fragmented parties and interest group coalitions. The past 40 years has witnessed the collapse of the middle ground in national policy institutions, as the parties realigned regionally and became more polarized, with political leaders playing more to the activists of newly reinvigorated parties. Members of Congress and Presidents became more focused on fundraising, fence mending and other activities in districts and less attentive to policymaking. David Mayhew chronicled the consequences for national policymaking – Members pursuing the “electoral connection” became concerned with

claiming credit for popular choices, generating visible benefits for their districts and avoiding blame for negative and sometimes unavoidable choices (Mayhew, 1978).

From these perspectives, a crisis appears to be the only way that the discounting problem and the asymmetries between narrow and broad interests can be addressed. First, a crisis overcomes the discounting problem by transforming the problem into one affecting current taxpayers. While current stakeholders may lose specific benefits from deficit reduction, they also realize immediate gains by the rescue of the broader economy that a crisis has made into a compelling and immediate concern. A crisis rebalances the intensity between narrow beneficiaries and broader taxpayers by making the diffuse costs of current policies more salient and visible to broader publics. It also makes the projected benefits from spending cuts and tax increases more compelling as well. Accordingly, a crisis succeeds in reversing the mobilization bias from the narrow beneficiaries of government programs to the broader publics.

It is important to define what we mean by a crisis. Given the absence of any commonly accepted threshold beyond which a problem merits categorization as a crisis, it may be said – as “social constructionists” stress – that any crisis is to some extent “a creation of the language used to depict it.” The definition and response to a crisis involves a contest between competing frames regarding severity, causes, responsibility and implications (Nohrstedt, Weible, 2010). Nonetheless, for purposes of this article, we would define a crisis as an exogenous event or “shock” bearing down on all actors of the system that requires some kind of policy response. This narrower definition helps us control for endogeneity where political leaders already committed to proactive fiscal policy contrive crises to mobilize support for their pre-existing positions. Given that the purpose of this paper is to explore whether crises motivate this commitment in the first place, we need to exclude endogenously created crises from our analysis.

The policy process literature also lends support to the notion that major policy change and fiscal sacrifice is a rare event indeed in advanced democracies. Traditional models of policymaking are generally based on the twin principles of incrementalism and negative feedback (Baumgartner, Jones 2003). Leading political scientists such as Aaron Wildavsky and Charles Lindblom concluded that the policy process has a conserving bias stemming both from political interests as well as institutional routines structuring and channeling change. In the United States, the Madisonian system’s checks and balances reinforce a perception of a system where major change must overcome numerous hurdles, sometimes called veto points. Major changes that did occur were viewed as principally orchestrated by strong Presidents with cohesive party support, and even strong Presidents required some kind of paradigmatic crisis to reinforce their leadership. In this traditional view, real reform required mobilization of mass political support sufficient to overcome the entrenched interests associated with current policies (Hayes, 2001).

Until relatively recently, budget processes were traditionally characterized as predominantly incremental. In the traditional works by Wildavsky and Fenno, budgeting at the federal level primarily focused on shifts in resources at the margin from the base. Incrementalism was justified both as an empirical observation as well as a normative framework, and studies revealed that it played out against a backdrop of consensus on the

overall budgetary base in the political system more broadly and in budgetary institutions more particularly (Wildavsky, 1964; Fenno, 1966). This characterization depicts a resource allocation process that corresponds to a largely pluralist world, where narrow interests prevail and where policy changes largely occur, if at all, only on the margin.

More recent work suggests that budgeting is characterized by dramatic and episodic shifts in resources for major programs that are anything but incremental. True, Baumgartner and Jones find that budget decisions for policy areas can veer from several years of stability to sharp periods of rapid change, corresponding to elections, economic and social changes and major reframing of policy issues (True, Jones, Baumgartner, 2007).

The stakes involved with budget decisions have grown exponentially as government's roles in the social and economic life of their nations have expanded in recent decades. While appropriations decisions can still largely be characterized as operating within the pluralist pathways, the calm world of appropriations have been supplanted by mandatory entitlements whose character does not lend itself to marginal changes, particularly when small cuts from growing baselines prompt widespread mobilization. Wildavsky's later editions recognized this shift by noting that the consensual base for budgeting had been replaced by budgetary dissensus over fundamentals (Wildavsky, Caiden, 2001).

Fiscal Rules: the balance wheel

Ironically, as the stakes involved with budget decisions grew and the political system became more conflictual, formal rules and structures became more essential for budgeting. Fiscal rules have come to be viewed as a replacement for the centrist coalitions, folkways and even moral consensus that used to form the parameters and glue that sustained a responsible center for budgeting. A recent IMF study shows that 80 nations have fiscal rules, compared to only 7 in 1990. Most have a combination of rules (IMF, 2009).

Ideally, fiscal rules and institutions can provide additional fiscal discipline. The rationale is to force all players in the process to overcome the common pool problem by internalizing fiscal effects of their actions. Thus, if a fiscal rule succeeds in forcing advocates to "pay for" new spending or tax cuts, this in itself could prevent the unlimited grazing of the fiscal commons by interests who would otherwise enjoy concentrated benefits.

Fiscal rules include a goal or target for deficits or debt over time, a set of processes for negotiating the budget including constraints on fiscal expansions, a set of institutional roles for budgetary actors designed to empower guardians over claimants, and information promoting transparency and accountability for budgetary outcomes (von Hagen). In many cases, fiscal rules and institutions have the goal of limiting the choices of democratic leaders, tying their hands to the proverbial mast to save them and their nations from their own hyper responsive tendencies. Whether it be delegating choices to a commission or providing for automatic formulas that trigger fiscal actions on cue from

certain indicators, the not so hidden agendas of many fiscal rules is to compensate for what are perceived to be the fiscal ambivalence of democratic leaders.

In the view of some, fiscal rules become reified as an alternative to politics. From this perspective, fiscal rules become a politically disembodied set of institutions that supplant normal political values and priorities. Roberts takes fiscal rules to task for a naïve institutionalism that seeks to rebalance fiscal power by curbing democratic sovereignty. A rule offers the promise of depoliticizing budget decisions. In Roberts' view, the use of fiscal rules is a reflection of the same lack of faith in democratic institutions and leaders to come to grips with important problems facing advanced nations (Roberts, 2010).

Much as proponents of such rules desire them to be self executing, in fact the effectiveness of rules ultimately depends on their alignment and support with political values and leaders. Wildavsky said it best – if the budget process is to be changed then one must alter the underlying political system as well. While often justified as a way to remove or defuse the political stakes inherent in budgeting, budget process reforms and fiscal rules in fact succeed only in changing the nature of influence and balance of power among the actors in the process (Wildavsky, 1961). Irene Rubin reminds us that budget reform can help carry out goals of politicians once they have made up their minds, but it cannot make up their minds (Rubin, 1990). As Roy Meyers has said, budget rules are endogenous to the political system which created them – which constitutes both strength and a weakness (Meyers, 2009).

Budget process reforms and fiscal rules in democratic systems have an independent effect more as a reinforcement to the substantive fiscal policy commitments made by political regimes rather than the catalyst forcing agreement on discipline and goals. Hallerberg and von Hagen's work shows that fiscal rules are most appropriate for coalitions where each party is bound to the overall political regime through contractual commitments. However, such rules become superfluous and often ignored in strong single party regimes that can rely on a hegemonic direction by the government leaders (Hallerberg, 2004). Similarly in the United States, fiscal rules are useful to bind a coalition to a set of policy goals already agreed to through political bargaining, but become irrelevant when the political regime changes. Thus, for instance, the PAYGO and spending caps agreed in 1990 were sustained for over eight years as a way to enforce fiscal goals subscribed to in a negotiated agreement between both parties. However, these same rules became superfluous and disregarded when President Bush was able to work exclusively with a Republican controlled Congress to unilaterally achieve his fiscal policy objectives without Democratic party assistance (Posner 2009).

The recent IMF study on fiscal rules worldwide reflected similar findings. In their conclusions, they observe that fiscal progress is fundamentally influenced by political institutions, public opinion and leadership, with rules playing a supplemental and important role. In many nations, rules were adopted several years after fiscal consolidation began to solidify and institutionalize political agreements (IMF, 2009).

Achieving the Politically Improbable

Notwithstanding the reigning pessimism about democracies and deficits, recent IMF data suggests that many nations have in fact undertaken significant fiscal consolidations in recent years. During the past three decades, there were 14 episodes in advanced economies and 26 in emerging economies when individual countries adjusted their structural primary balance by more than 7 percentage points of GDP. Several economies were also able to sustain large primary surpluses for five or more years afterwards. Large fiscal adjustments occurred simultaneously in more than half of the advanced European economies in the mid-1990s, especially in the run-up to the European Monetary Union. The IMF concludes that judging from past experience, such a major adjustment will no doubt be difficult, but is possible (Cotarelli, 2010).

Economist Henry Aaron has noted that many advanced nations have achieved even more significant swings in the primary balance in recent years. The following table illustrates that many nations have achieved significant and sustained reductions of deficits and debt including the United States (Aaron, 2010):

Nation	Period	Fiscal Swing as %GDP
Australia	1992-2000	7.5%
Canada	1992-2000	11.1
Finland	1992-2000	12.3
New Zealand	2000-2006	5.9
Sweden	1993-2000	14.9
United Kingdom	1993-2000	11.7
United States	1992-2000	7.4

Much of the academic literature and conventional wisdom discussed above would not predict that many nations would step up to take on fiscal consolidation until forced to by the not so invisible hand of credit markets. It is indeed the case that some of these nations did face pressure from credit markets; Sweden and Canada are two nations where deficits and debt rose to levels that threatened economic competitiveness and interest rates. However, most of these nations did not face an externally defined market crisis with the prospects of creditors refusing to purchase government issued debt. Moreover, in nations such as the United States, fiscal retrenchment fell into the important but not urgent category, as domestic political factors rather than credit markets became the primary drivers forcing fiscal consolidation.

Rather than an absolute precipitous crisis, most of these nations faced a more incremental set of pressures manifesting themselves in changes in prices and costs associated with their debt and currencies. As capital markets have become more global, competition among nations for global financing has made them more sensitive to the needs of market actors for stable economies and debt levels. Market pressures have well known independent effects, as public officials are able to link economic outcomes that matter to

broader publics to fortify the case for fiscal restraint and discipline (Garrett, Lange, 1991). Many fiscal consolidation initiatives have been undertaken on a procyclical basis during the trough of recessions, as a result of pressure from restive worldwide credit markets. Such consolidations have become known as “expansionary fiscal contractions” to denote the counterintuitive effects of fiscal retrenchment to promote growth and recovery (Committee for a Responsible Federal Budget, 2009).

There are nations such as Argentina where procrastination can in fact lead to a market driven external shock and crisis. However, the nations in the table above have distinguished themselves by dealing with problems constructively before they became truly destructive and uncontrollable by government action. In nations such as Australia and New Zealand, national officials were able to use the specter of anticipated credit market responses to take proactive fiscal actions designed to head off a precipitous fiscal shock. Far from illustrating the weakness of democracies, these leadership induced policy anticipations suggest how democratic nations can be guided to act with foresight and intelligence.

Most recently in 2011, OECD responses to the fiscal crisis varied. Some nations like Greece and Hungary delayed needed reforms until markets demanded a response, causing those nations to adopt policy reforms that were highly disruptive both economically and politically. On the other hand, nations like the Netherlands and the United Kingdom responded in a more proactive manner by taking initiatives to cut spending and raise revenues through more deliberative action that received broader support. Several nations, such as the United States and Japan, delayed cuts due to concerns over near term economic recessions.

When such nations in fact construct and implement credible plans to reduce spending and increase revenues, the conventional view would conclude that political leaders have arrived at these options only as a last resort. And most assuredly, having undertaken a politically unnatural act, those government leaders would surely not survive politically for very long after their courageous actions.

Conventional wisdom and academic theory to the contrary, intriguing studies suggest that not only have national leaders taken the initiative to pilot consolidation through the political straits, but they were rewarded electorally as well. Brender and Drazen used data from 23 OECD nations from 1960 through 2003 on 164 elections. They found that governments achieving lower deficits through policy actions actually increased the probability of their reelection. Controlling for changes in the economy, a reduction of 1 percentage point in the deficit/GDP ration increased the probability of reelection for existing regimes by 5.7 percentage points. The authors attribute this surprising finding to the fact that voters do not like deficits because they perceived that this will entail future tax increases or spending cuts in subsequent years (Brender, Drazen, 2006).

A 1998 study published by Brookings echoed similar findings. When examining whether governments following tight fiscal policies tend to lose popularity or are replaced in office, the researchers found the answer to a “loud no” to both questions. If anything, the opposite proved to be the case: when deficits are reduced, governments that follow a "cold turkey" approach and focus on spending cuts may be rewarded at the ballot box. If anything, more radical fiscal adjustments were associated with a lower probability of a change in government. During sharp adjustments that rely primarily on spending cuts in general, and on the major components of government wages and transfers, in particular, the probability of government survival increased (Alesina, Perotti, Tavares, 1998).

Several qualitative analyses of the politics of fiscal austerity in selected advanced nations come to similar conclusions. The U.S. Government Accountability Office study of deficit reduction in select OECD nations in the late 1980's revealed that these nations instituted often painful measures to reach fiscal balance or surplus while generating and maintaining political support. Specifically, Australia, Germany, Japan, Mexico, and the United Kingdom moved from fiscal deficits as high as 16.9 percent of GDP to balance or surplus in the 1980s or early 1990s. Various factors prompted governments to adopt deficit reduction strategies. Of the six governments studied, only Mexico was forced to take deficit reduction measures as a consequence of economic crisis and the reaction of external credit markets. In all others, leaders defined the turning point in fiscal policy rather than waiting for a financial crisis to trigger decisions. Some reacted in part to fears of eventual negative external market reaction, but all drew upon internal economic concerns such as inflation and interest rates. Leaders used these themes to create a sense of urgency for reducing the deficit.

Importantly, these governments closed significant budget gaps while being returned to office, in some cases several times over. While fiscal austerity was difficult and politically challenging, astute and savvy leaders developed effective political strategies to build consensus and gain public support. Trading large cuts in one program for improvements in other ones, targeting cuts to higher-income beneficiaries, pursuing “shared sacrifice” strategies, and phasing in reductions over time all helped to reduce the impact of cuts on current beneficiaries. While many of these nations did backslide into deficits with the recessions of the early 1990's, the episode of fiscal retrenchment enabled the GAO to conclude that significant structural policy changes and sacrifice is indeed compatible with democratic politics (U.S. GAO, 1994).

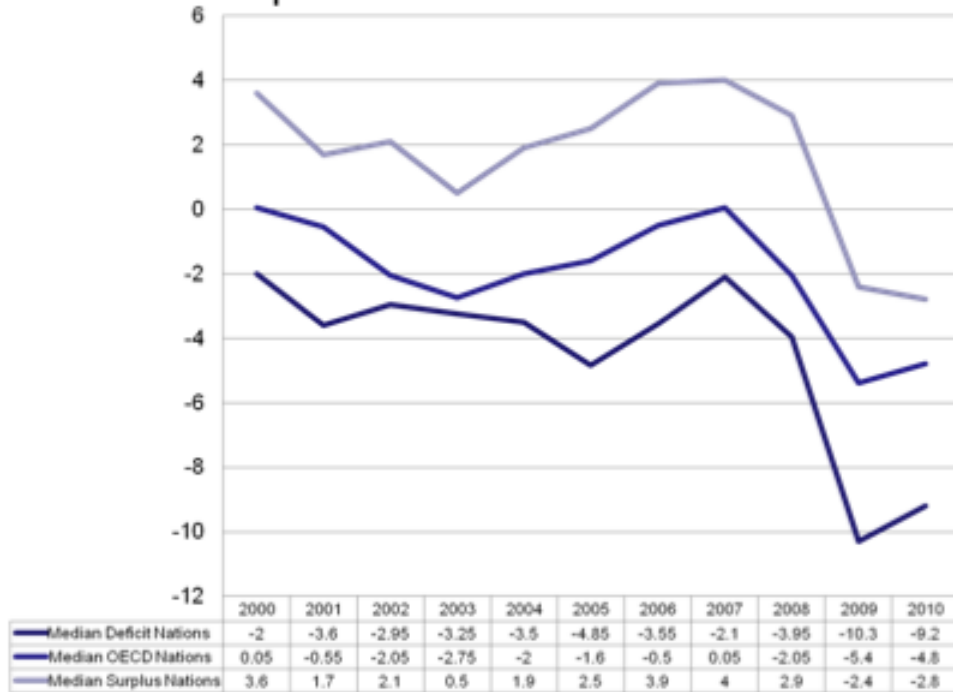
The United States, too, has taken some significant steps in recent years to change the course of fiscal policy. In 1983, the National Commission on Social Security Reform (known as the Greenspan Commission, after its chair) formulated convincing analyses and arguments that led to political consensus for reforms to Social Security. The reform, which included both tax increases and reductions in benefits for retirees, did not fully solve the program's sustainability problems but it greatly ameliorated them. Similarly, in 1990, the nation adopted a budget agreement that constituted significant deficit reduction, to be followed by similar action in 1993; That agreement, engineered by leaders of both major parties, helped turn the federal government from then-chronic deficits to a 4-year period of budget surpluses.

A study by one of the co-authors of this paper of the persistence of budget surpluses for a number of years in nations such as New Zealand, Sweden and Australia reached similar conclusions about the political appeal of fiscal restraint. The continuation of budget surpluses even during the recession in 2000 challenged the prevailing orthodoxy of public choice and many political economists again. The leaders in the nations studied were successful in mobilizing public support behind continued fiscal prudence and surpluses, even following years of deficit reduction. Several nations – Sweden, New Zealand and Norway - instituted spending cuts to sustain surpluses during this period. Remarkably, New Zealand enacted budget cuts to sustain surpluses in the face of the Asian economic crisis, which had originally been projected to prompt renewed deficits in the absence of policy actions.

This is not to say that fiscal austerity comes naturally to any system. Rather, the nations were acutely aware of the fragility of fiscal restraint and the political vulnerabilities of those pressing for continued restraint after years of deficit reduction. Building on this understanding, in fact, these governments engaged in sophisticated initiatives to build their case by tying this policy goal to broader national concerns and anxieties. Most importantly, deficit reduction and surplus retention were adroitly defined as a relevant, appropriate, and even necessary response to recent economic crises experienced by each of these nations (Posner. Gordon, 2000).

In the fast moving politics of 2011, nations have experienced a wider range of political outcomes. Those nations that procrastinated for fear of political fallout ironically brought about the worst political outcomes. Their delays led to higher deficits and more drastic fiscal remedies that caught domestic publics by surprise, bringing down several governments in the process. By contrast, governments that ran sustained surpluses through much of the decade weathered the financial crisis with far less drastic fiscal remedies and political fallout. The chart below shows that the nations that had run persistent surpluses had relatively modest deficits in 2010 of 2.8 percent of GDP compared with deficits of 9.2 percent of GDP for those OECD nations with the most severe and chronic fiscal problems.

Deficit/Surplus as Percent of GDP



Understanding the politics of fiscal austerity

It is important to understand what factors help influence governments to mount politically successful campaigns for fiscal retrenchment. Considerable thought has gone into explaining why fiscal choices are so politically unrewarding. It is time for policy analysts and political scientists to devote time to the qualitative and quantitative research understanding the other side of the political equation – how leaders can structure these choices so they can survive, and even thrive.

First, why do democratic leaders decide to undertake fiscal consolidation in the absence of a crisis? As noted earlier, conventional wisdom suggests that leaders have shortsighted time horizons, and the political rewards of consolidation are likely to be overshadowed by near term political reaction. However, recent research suggests that political leaders are less focused on catering to or pandering to median voters and more on pursuing the policy goals of their own coalitions. Political leaders in a more polarized system have strong ideological views and supportive coalitions that drive their positions on policy issues. These leaders pursue crafted talk to link their own proposals to the prevailing moods of the broader publics (Jacobs, Shapiro, 2000).

This dynamic can promote greater attention to fiscal consolidation by elites concerned about the longer term outlook for national economies. Keech, among others argues that political leaders have to exercise at least a modicum of economic foresight because voters judge them based on retrospective voting – i.e. how well the economy has done under the leader’s term. Leaders are penalized if rising debt and deficits lead to higher interest rates, inflation and currency crises. Factors such as these accounts for the history of budget balance and fiscal consolidations that have occurred in many democratic regimes (Keech, 1995).

Indeed, savvy political leaders have proved adept at framing deficit reduction as an economic growth program. They are able to lay economic problems such as high interest rates and inflation at the doorstep of high deficits. The sacrifices involved in fiscal consolidation must be justified by pointing to prospective economic gains in the near term, whether it be easing credit market pressures or staving off the potential for a full-scale exogenous debt crisis. Indeed, if the size and credibility of the package are impressive, the “announcement effect” creates a self-reinforcing virtuous cycle, prompting financial markets to lower interest rates at the outset when the consolidation package is established and enacted.

Of course any democratically elected official has to be constantly aware of the public’s views on fiscal policy. In this regard, leaders can take advantage of what amounts to a profound ambivalence by the broader public about fiscal policy and consolidation. Typically, publics do not like deficits but also have strong support for continuing current taxes and spending programs. These conflicting views change in relative salience over time, providing openings for leaders to mount campaigns. In the United States, the deficit ranked as the top concern in the late 1980’s and early 1990’s, corresponding with two major successful initiatives to reduce deficits which ultimately led to budget surpluses later in the 90’s. In 2010, polls in the United States and United Kingdom show publics almost evenly split between cutting deficits or spending more on economic recoveries.²

Leaders must also cover their political risks by pursuing strategies that enable them to craft deficit reduction packages that spread the sacrifice and help obfuscate blame for imposing painful decisions. Framing the exercise in compelling terms is critical to justify the sacrifice, as noted above. Beyond this, Paul Pierson has noted some classic strategies pursued to facilitate the imposition of losses in advanced democratic nations (Pierson, 1994):

- Divide and conquer –target cuts on some parts of a coalition
- Compensation of losers
- Hiding visibility of changes
- Blame avoidance
- Systemic retrenchment that makes longer term changes in future by reforming political institutions, making tax increases or cuts more difficult through indexing, decentralization, budget rules, etc.
- Phasing in cuts

Douglas Arnold suggests that many of these strategies help democratic leaders protect themselves against the political risks associated with fiscal consolidation (Arnold, 1992). He stresses the importance of designing policies to obfuscate or share blame. Hiding painful choices in larger omnibus legislation can buffer the traceability chain and enable legislators to avoid taking politically difficult votes. Delegating hard choices to independent bodies such as commissions or executive agencies is another time-honored strategy to spread blame and avoid blame.

Other strategies have proved critical to sustaining political support for fiscal consolidation. The timing and size of fiscal consolidations are important. Introducing consolidation right after an election is often associated with success, as leaders are often in their “honeymoon period” and have maximum political capital. The size of fiscal adjustments is also related to success. Larger more broad sweeping changes have ironically been found to be positively related to political success. This may be partly because success is a function of the size of the fiscal gap, with political rewards accruing to those systems with the most dramatic and deepest fiscal challenges (Brender, Drazen, 2006). However, other research suggests that large packages help spread the pain and can head off prisoners dilemma problems. A former high Swedish finance official writes that a broader package of changes helps offset distributional effects, particularly if both spending cuts and tax increases are included (Henriksson, 2007). OECD research suggests that large multi-year adjustments can make reforms possible that would not have been able to find support on their own . (OECD, 2010) As noted earlier, fiscal rules can play an important role of solidifying commitment to retrenchment once fundamental political choices have been made.

Of course, nations have highly differential responses to the challenge of fiscal consolidation. Research suggests that political institutions make a difference. Cohesive single parties controlling government are more likely to develop and successfully achieve fiscal consolidation packages than fragmented coalitions. Coalition partners often have difficulty agreeing on packages compared to more unified parties (Larch, Turrini, 2008). Since proportional representation systems tend to foster politically fragmented regimes, some have generalized that governments with majoritarian electoral systems maintain tighter fiscal discipline than other systems (Perrson, Tabellini, 2003). Tsebelis shows that governments with fewer veto players are able to promote broader scale change.

More recently, the policy process literature has recognized a greater volatility and potential for major change than had heretofore been the case. Widely noted shifts in our political institutions created greater opportunities for new issues and interests to take root. In the United States, the Congress became a more open and decentralized body by maximizing credit claiming opportunities for members to take the lead on a variety of issues, both old and new. Interest group systems became more diverse and competitive as new broader based interests showed an inclination and capacity to organize, leading some scholars to spurn iron triangle metaphors for more open concepts such as networks or advocacy coalition frameworks (Sabatier, Jenkins-Smith, 1993). The media presence in policymaking expanded and exploded with more outlets combing political capitals worldwide for new issues and problems. In the United States, these trends bore fruit with major new policy innovations in the past 30 to 40 years that many would have thought

impossible under traditional models. Whether it be environmental protection, deregulation, tax reform, farm reform or welfare reform, major policy changes were indeed enacted in ways that at the time seemed idiosyncratic, remarkable or shamelessly hasty.

The literature began to reflect a process that was more open to change and far less predictable than traditional models acknowledged. Case studies of major policy reforms - Derthick and Quirk on deregulation, Beam, Conlan and Wrightson on tax reform – identified a new politics of reform where the churning of ideas and their expert purveyors played a far more central role in generating and sustaining change than had heretofore been recognized.

The presence of a more fluid and dynamic policy process is reflected in the multiplication of avenues and arenas that incubate and mobilize broader publics to support policy reforms and fiscal changes alike. These multiple arenas draw on what the co-author and several colleagues have characterized as four “pathways to power”: pluralist, partisan, expert and symbolic (Posner, Conlan, Beam, 2004). In this model we characterize four pathways to power characterized by two dimensions - the scope and scale of mobilization (whether specialized or mass) and the method of mobilization (principally whether interests or ideas were at play). These dimensions suggest that policies come to the agenda and enactment through four discrete “pathways of power” as shown in Table 3.

Table 3: The Pathways to Power

Scope of mobilization/ Basis of mobilization	Narrow	Broad
Interests	Pluralist	Partisan
Ideas	Expert	Symbolic

The pluralist pathway was the political and institutional grounding for public choice theory and incrementalism, as the relevant interest groups and other specialized actors in appropriations committees and agencies exercised hegemonic influence and control over discrete budgetary areas, ranging from veterans to public health to transportation (Cogan, Muris, Schick, 1994). In some respects, much of the pessimism over the potential for fiscal retrenchment and the adoption of policy reforms stems from the rather static view of the policy process as being captured by narrow pluralistic interests.

The other three pathways have emerged as alternative bases for mobilizing publics on behalf of fiscal and policy change. Party leaders have traditionally been conceived as the major broad based change agents, capable through leadership of mobilizing broad publics to outflank and shift the framing of issues away from the narrow confines of pluralistic bastions.

The idea-based pathways have emerged in recent decades to offer an alternative basis for reframing policy issues and providing newly legitimate and appealing ways to change the political calculus of consent. Public officials have become increasingly attracted to symbolic budgetary proposals to position themselves on the “right side” of fiscal, tax or entitlement policy issues. Ideas in this pathway are championed not for their technical adequacy but for their potential to appeal to widely shared values or moods, often providing deceptively simple or apparently costless approaches to wrenching budgetary choices. When issues fall into the expert pathway, professional knowledge and technical feasibility become the source of legitimacy against which all proposals are based. Experts’ roles in the process have become fortified by the growing need for credible numbers and models to understand increasingly complex relationships between federal programs, the economy and performance outcomes.

Secular changes in institutions have promoted greater potential for pathway shifting in our system than ever before. More competition among interest groups in the pluralist pathway, more media outlets vying for audience share in the symbolic pathway, greater presence and salience of experts and more competition among elected officials anxious to use policy issues to fortify their standing with various publics have all served to heighten the potential for policy change. Greater competition among these actors prompts actors to switch pathways to gain strategic advantage.

For fiscal policy, these shifts constitute at least a double-edged sword. Both fiscal claimants and guardians can employ the four pathways to achieve very different policy objectives. Policy claimants can use symbolic and expert pathways to mobilize support for new entitlements and tax cuts that can undermine fiscal goals and constraints. On the other hand, guardians and political leaders have proved adept at framing the case for deficit reduction in ways that borrow from the arsenal used by advocates. Timothy Sinclair has argued, for instance, that political elites in many OECD nations have embraced fiscal discipline and the so-called “deficit discourse” as the reigning public philosophy of the day (Sinclair, 1998). Fiscal consolidation strategies and arguments have gained strength thanks to the savvy use of more open policymaking processes to reach broader publics. Leaders have a greater chance to frame their case for fiscal austerity in terms that broad publics can support. The symbolic pathway for instance can be used to embarrass interest groups in the pluralist pathway who can be framed as obstacles to fiscal and economic progress.

Conclusions

Advanced nations face nearly unprecedented fiscal challenges, both for the medium and longer term. The Great Recession has added to fiscal pressures and public debt, while at the same time deferring the ability of nations to begin fiscal consolidation initiatives. Ironically, the recent financial tumult in European bond markets has provided a real

market driven crisis that is requiring hard pressed nations to begin consolidation in the trough of a recession.

Daunting challenges lie ahead in the next several decades for democratic nations and their leaders. Fiscal retrenchment calls for a level of sacrifice that tests the foresight and resolve of a democracy. Near term economic pressures have combined with longer term secular forces to deepen fiscal gaps facing OECD nations. As the role of government in the social and economic life of nations has grown, so has the stakes of budgeting. Accordingly, the choices have become more difficult even while the number of stakeholders and the pathways to power have become more diverse. Politics is far less predictable and decision-making far more open than ever before.

Notwithstanding these forces, the magnitude of the fiscal challenges has heightened the importance of early action and foresight in fiscal policymaking. The best chance of effectively dealing with the fiscal forces building up in aging societies is to make timely decisions that have the broad support of as many interests and actors as possible. There is no way to underestimate the difficulties this poses for democratically elected leaders. We do not underestimate the dilemmas faced by leaders who must seek reelection while at the same time demanding extraordinary fiscal sacrifice from their citizens. And there are certainly many cases where democratic nations have failed to rise to this challenge

However, this does not mean that democratic politics and fiscal opportunities inherently clash. As contrasted with conventional wisdom and certain academic literatures, we believe that democratic nations are not doomed to be reactive to market pressures alone. Rather policymakers and publics alike can be summoned to fiscal sacrifice and longer term vision by compelling ideas presented in ways designed to mobilize broader publics traditionally unengaged in budget decision-making. While pluralistic interest groups may never voluntarily give up hard won benefits, other pathways to power can be marshaled to outflank and reframe budget debates to seize higher ground. Democratic nations can and have made hard choices in the past. As world economies have become more interdependent, it becomes ever more vital to ask how more nations can be prompted to take the initiatives to respond proactively to the major fiscal challenges of our time.

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² For the United States, see Woodrow Wilson Center discussion by Carroll Doherty at http://wilsoncenter.org/index.cfm?topic_id=1412&fuseaction=topics.event_summary&event_id=602832. For the United Kingdom, see <http://www.guardian.co.uk/commentisfree/poll/2010/feb/19/public-finance-economy>