Democracies and Deficits

Paul Posner, George Mason University
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General Government Deficit vs. Debt in Euro Area Countries, 2011
Figure 1.2. Substantial consolidation required to stabilise or reduce debt by 2025

Required improvement in underlying primary balance, % of potential GDP
Table 2. Consolidation requirement to stabilize the debt-to-GDP ratio over the long-term horizon

<table>
<thead>
<tr>
<th></th>
<th>Underlying primary balance in 2010 (A)</th>
<th>Underlying primary balance required to stabilize debt (B)</th>
<th>Required change in underlying primary balance (C) = (B) - (A)</th>
<th>Change in underlying primary balance in 2011 (D)</th>
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1. Underlying primary balance required in 2025, based on gradual but steady consolidation paths, to stabilise debt-to-GDP ratios over the long-term horizon, embodied in the long-term baseline scenario presented in OECD Economic Outlook 87. Debt stabilisation may take place at undesirably high levels.

Source: OECD calculations.
NPV of Pension and Health care Spending Change 2010–50

(Change in percent of GDP)
Need for early action

• Stein’s law

• Advantages of early action
  – Avoid the pain of a fiscal shock
  – Intercept vicious cycle of interest costs
  – Improve economic growth
  – Secure smoother transition to program reform
  – Promote political stability
The Costs of Delay

Reductions in Primary Spending or Increases in Revenues in Various Years Needed to Close the 25-Year Fiscal Gap Under CBO’s Alternative Fiscal Scenario

(Percentage of gross domestic product)

Source: Congressional Budget Office.
A Deficit Bias?

- **Spending bias**
  - Groups benefitting from subsidies more easily mobilized than broader publics who must pay
  - Beneficiaries of existing programs become dependent and resistant to change
- **Political officials incentives**
  - Claim credit
  - Avoid blame
- **Short sighted time frames**
- **Political business cycle** – governments reap electoral rewards from higher deficits
Erosion of faith

• Advanced democracies are incapable of
  – Acting with foresight
  – Instituting fiscal sacrifice
  – Nordhaus – “A perfect democracy with retrospective evaluation will make decisions biased against future generations.”

• Political leaders face electoral retribution not reward from fiscal consolidation

• Ambivalence of credit markets
Policy Process Models: Bias against major policy actions

- Incrementalism
- Political fragmentation and divided government
- Pluralism strengthens claimants vs. guardians
- Recent trends exacerbate leadership challenge
  - Party polarization
  - High stakes budgeting
The Need for a Crisis

• Defining crisis
  – Exogenous vs. endogenous

• The political function of a crisis
  – Urgency
  – Mobilization of broader publics
  – Overcoming discount rates

• The role of external crisis in achieving long lasting fiscal change
Political fallout following fiscal crises

- Precipitous changes required in long standing commitments
- Often procyclical shifts in fiscal policy must be taken in the face of economic downturns
- Government rescues of the financial sector and high debt costs erode fiscal room and undermine legitimacy of government policy
- Priorities are distorted in favor of strategies yielding immediate savings, such as tax increases
- The economic crisis makes it difficult to realize short term benefits from consolidation policy shifts
The Political Fallout

• Ireland - worst defeat of a sitting government since the formation of the Irish Republic in 1921
• Greece - general strikes and massive protests against labor and spending reforms lead to Papandreou resignation
• Portugal - rejection of externally imposed austerity measures forces Prime Minister Socrates to resign
• Spain – recession and harsh austerity measures lead to defeat of ruling party by largest margin in Spanish election history
• Iceland - banking and economic crisis led to ouster of Independence Party which had been in power for 18 years.
Achieving the Politically Improbable

<table>
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<th>Nation</th>
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<th>Fiscal Swing as %GDP</th>
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The Politics of Fiscal Austerity: How Can Leaders Overcome Opposition

– Public ambivalence about fiscal consolidation
– Cyclical public views on importance of deficits
– Leaders can reframe what the debate is about
  • Shifting focus from one area of public consensus to another
  • Public both wants benefits protected and strong economy
Deficit Concerns Climb

% who say reducing budget deficit is "top priority"

PEW RESEARCH CENTER Jan. 11-16, 2012. Q35b. From 1998 to 2001 question asked about "paying off the national debt" rather than "reducing the budget deficit."
Would you support or oppose a deficit reduction plan that included cuts to Social Security and Medicare?

- Support: 13%
- Neither support, nor oppose: 15%
- Oppose: 60%
- Not sure: 11%

YouGov
today.yougov.com
Would you support or oppose a deficit reduction plan that included increased taxes?

- All respondents: Support 24%, Neither support, nor oppose 47%, Oppose 18%, Not sure 11%
- Republicans: Support 9%, Neither support, nor oppose 71%, Oppose 15%, Not sure 5%
- Democrats: Support 39%, Neither support, nor oppose 32%, Oppose 19%, Not sure 10%

YouGov: today.yougov.com
The Politics of Austerity: What are the Incentives?

• Political incentives
  – Retrospective voting and the economy
  – Political space

• Market pressures
  – Interest rates
  – Currency values
  – Bond vigilantes

• Long term time horizons of elites
  – Elected officials
  – Interest groups

• Norms of fiscal performance

• Political timing
  – Post election
Multiparty Strategies to Reform Pensions

• The political cohesion of governments is important
  – Strong majoritarian parties are important but....

• Multiparty coalitions are often necessary
  --Canada – reform of the Canada Pension Plan was adopted after two-thirds of the provinces supported the arrangement.
  --Spain – the 1996 Toledo Pact is an all party agreement ratified by unions and employers association for reform of the Spanish old age security system.
  --Sweden – the 1998 reform was developed through an all-party agreement resulting in incentives to prolong work and create notional accounts.

• United States – 1983 commission developed a bipartisan pension reform extending retirement age and raising taxes.
## A more dynamic policy process

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Fiscal consolidation strategies

• Nature of fiscal consolidation strategies
  – Crucial role of framing
    • Link to broader economic and policy goals
    • Create endogenous crisis
  – Larger more sweeping changes
  – Balance between spending and revenue
  – Phased in cuts
  – Shared sacrifice
  – Compensation
  – Blame avoidance – obfuscating sacrifice
  – Delegation – “passing the lack of bucks”
The politics of fiscal rules

• Roles for fiscal rules
  – Dependent on prior political commitment
    – Formative role of political institutions, public opinion and leadership
  – Reinforce commitment by coalitions rather than a catalyst for commitment
    – The history of PAYGO in the United States
  – Strengthen central leadership vs. other actors
  – The underappreciated role of shame
Achieving the politically improbable

• Brender and Drazen data on 23 OECD nations
  – For every 1 percent cut in deficit/GDP due to policy change, election probability rises 5.7%

• Brookings 1998 (Alesina, Perotti, Tavares)
  – Leaders rewarded for fiscal sacrifice at the polls
  – More radical adjustments improve reelection
Achieving the politically probable

• GAO 1994 study of six nations
  – Major fiscal gaps closed in 1980’s
  – Leaders rather than markets determine timing
  – Backsliding on deficits in 1990’s – a political deficit reduction cycle

• Surprising retention of budget surpluses in selected nations
  – Sustained through recession of early 2000

• Major pension reforms help sustain progress
Conditions Enabling Political Survival

• Goldilox economy – neither too hot or too cold
  – Strong economy provides best timing economically but least incentive politically to make hard choices
  – Recessions provide greater fiscal urgency but also greater reluctance to engage in fiscal cutbacks
  – Monetary policy is critical enabler

• Path dependency leaves fiscal legacy
  – Governments stand on the shoulders of previous governments

• Fiscal resilience
  – Previous fiscal surpluses leaves low debt and interest costs

• Market pressures
  – Need to anchor loss imposition to fear
  – Echo of past crises can continue to inspire sacrifice for decades
Conditions Enabling Political Survival

• Leadership, not the public, provides the impetus
• Longer term fiscal goals provide framework for changes
• Strong party regimes
  – Coupled with ability to form crosspartisan agreement
  – Particular leverage enjoyed by parties taking counterintuitive actions
• Collaboration with key interest groups
  – Corporatist frameworks achieve buy in
  – Short term concessions and long term staging of reforms can blunt opposition