

Democracies and Deficits

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IMF Fiscal Data, January 2012

| | 2008 | 2009 | Est. 2010 | Projections 2011 | 2012 | 2013 |
|-------------------------------|------|-------|--------------|---------------------|-------|------|
| Overall Fiscal Balance | | | | | | |
| World | -2.0 | -6.7 | -5.5 | -4.5 | -4.1 | -3.4 |
| Advanced economies | -3.8 | -9.0 | -7.6 | -6.6 | -5.7 | -4.6 |
| United States | -6.7 | -13.0 | -10.5 | -9.5 | -8.0 | -6.4 |
| Euro Area | -2.2 | -6.5 | -6.3 | -4.3 | -3.4 | -2.9 |
| France | -3.3 | -7.6 | -7.1 | -5.7 | -4.8 | -4.4 |
| Germany | -0.1 | -3.2 | -4.3 | -1.1 | -0.7 | -0.1 |
| Italy | -2.7 | -5.3 | -4.5 | -3.9 | -2.8 | -2.3 |
| Spain | -4.2 | -11.2 | -9.3 | -8.0 | -6.8 | -6.3 |
| Japan | -4.7 | -10.8 | -9.3 | -10.1 | -10.2 | -8.8 |
| United Kingdom | -4.9 | -10.4 | -9.9 | -8.6 | -7.8 | -6.5 |
| Canada | 0.1 | -4.9 | -5.6 | -4.9 | -4.4 | -3.6 |
| Emerging economies | -0.4 | -4.8 | -3.6 | -2.6 | -2.7 | -2.5 |
| China | -0.4 | -3.1 | -2.3 | -2.0 | -2.0 | -1.4 |
| India | -7.2 | -9.7 | -8.9 | -8.5 | -7.9 | -7.6 |
| Russia | 4.9 | -6.3 | -3.5 | 0.5 | -1.4 | -1.7 |
| Brazil | -1.4 | -3.1 | -2.8 | -2.6 | -2.4 | -2.3 |
| Mexico | -1.1 | -4.7 | -4.3 | -3.0 | -2.7 | -2.1 |
| South Africa | -0.5 | -5.3 | -5.1 | -4.9 | -4.8 | -4.2 |
| Low-income economies | -1.3 | -4.0 | -3.1 | -2.8 | -2.8 | -2.3 |

General Government Deficit vs. Debt in Euro Area Countries, 2011

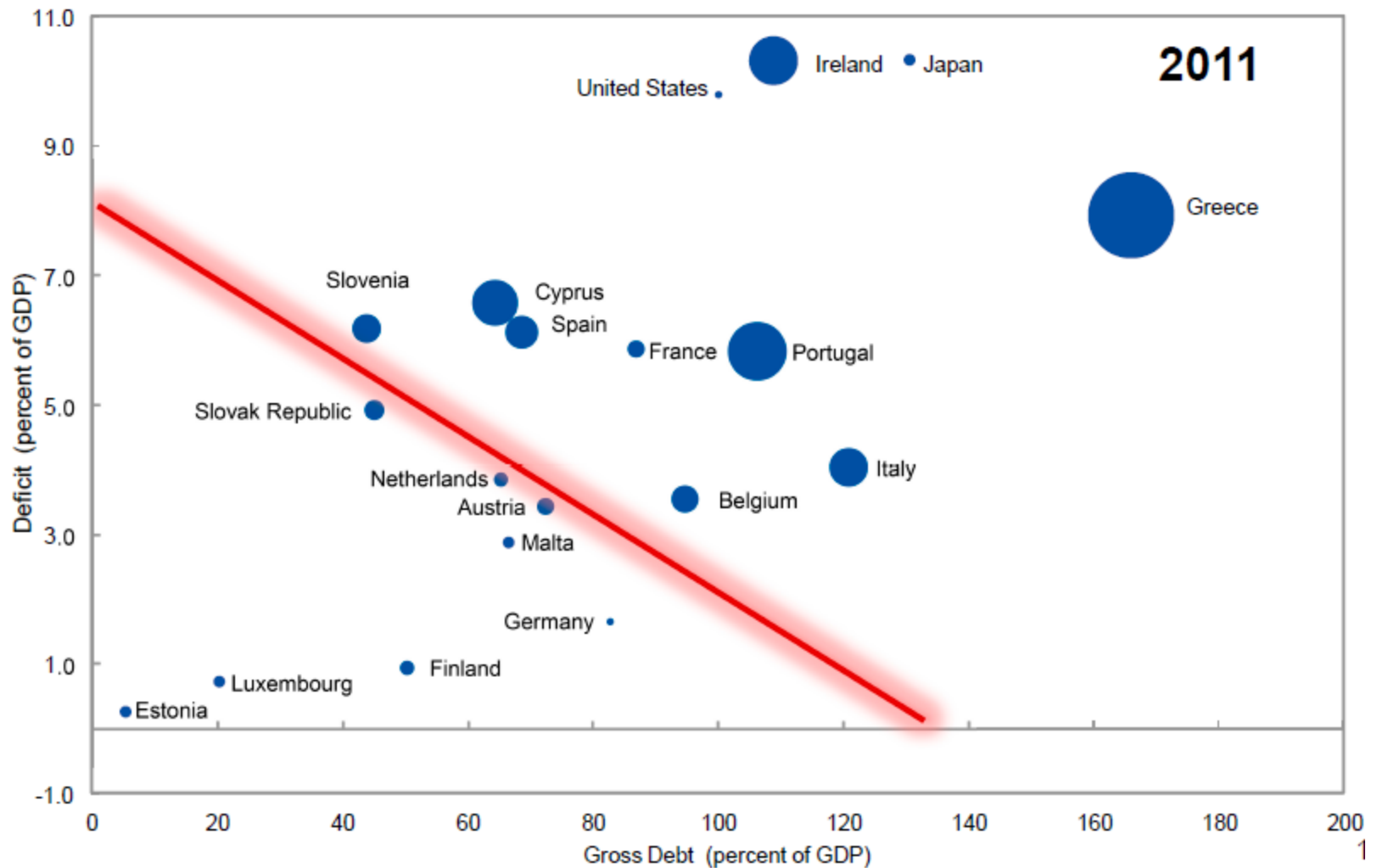
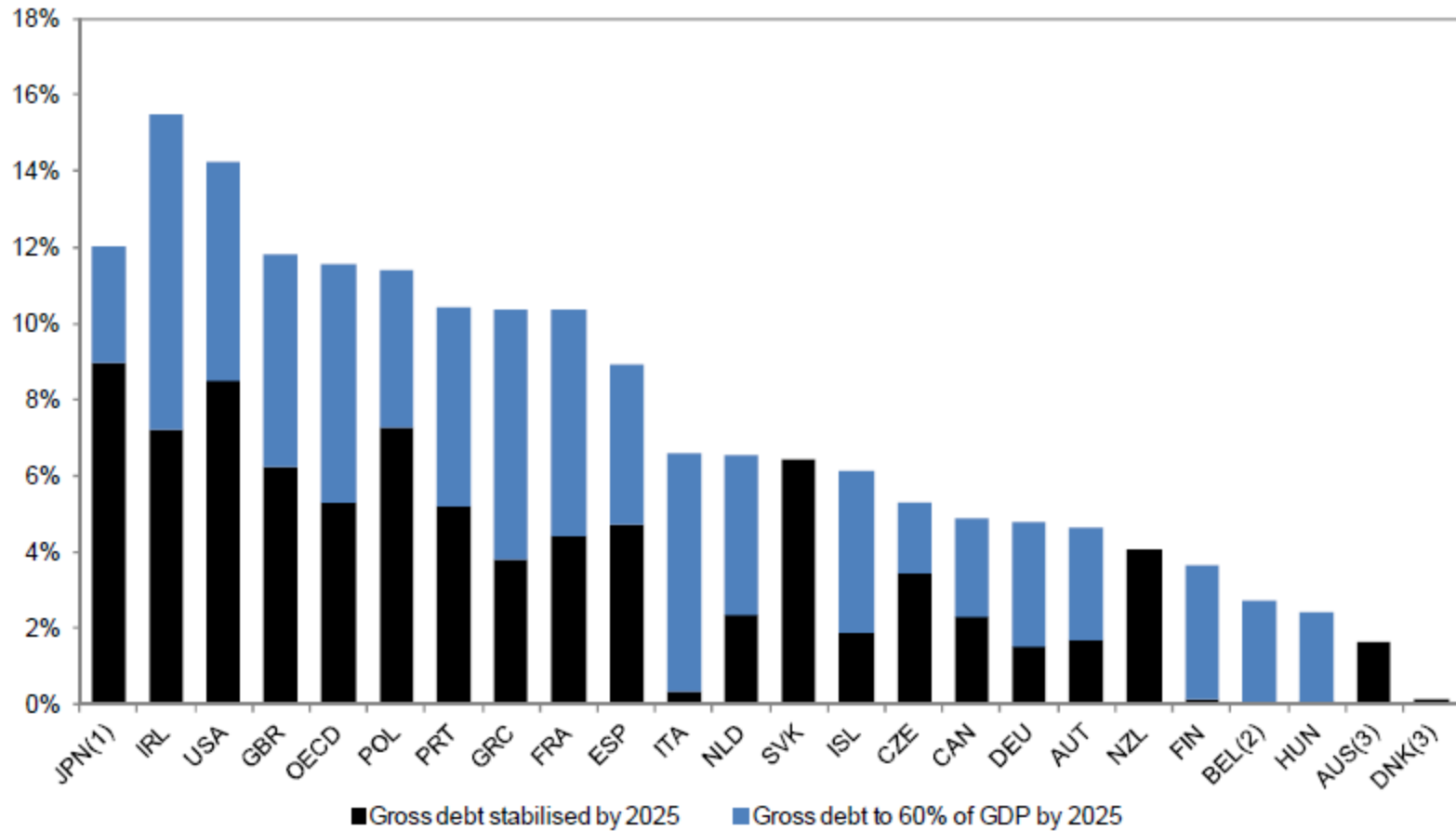


Figure 1.2. Substantial consolidation required to stabilise or reduce debt by 2025

Required improvement in underlying primary balance, % of potential GDP



OECD Long Term Fiscal Outlooks

Table 2. Consolidation requirement to stabilize the debt-to-GDP ratio over the long-term horizon

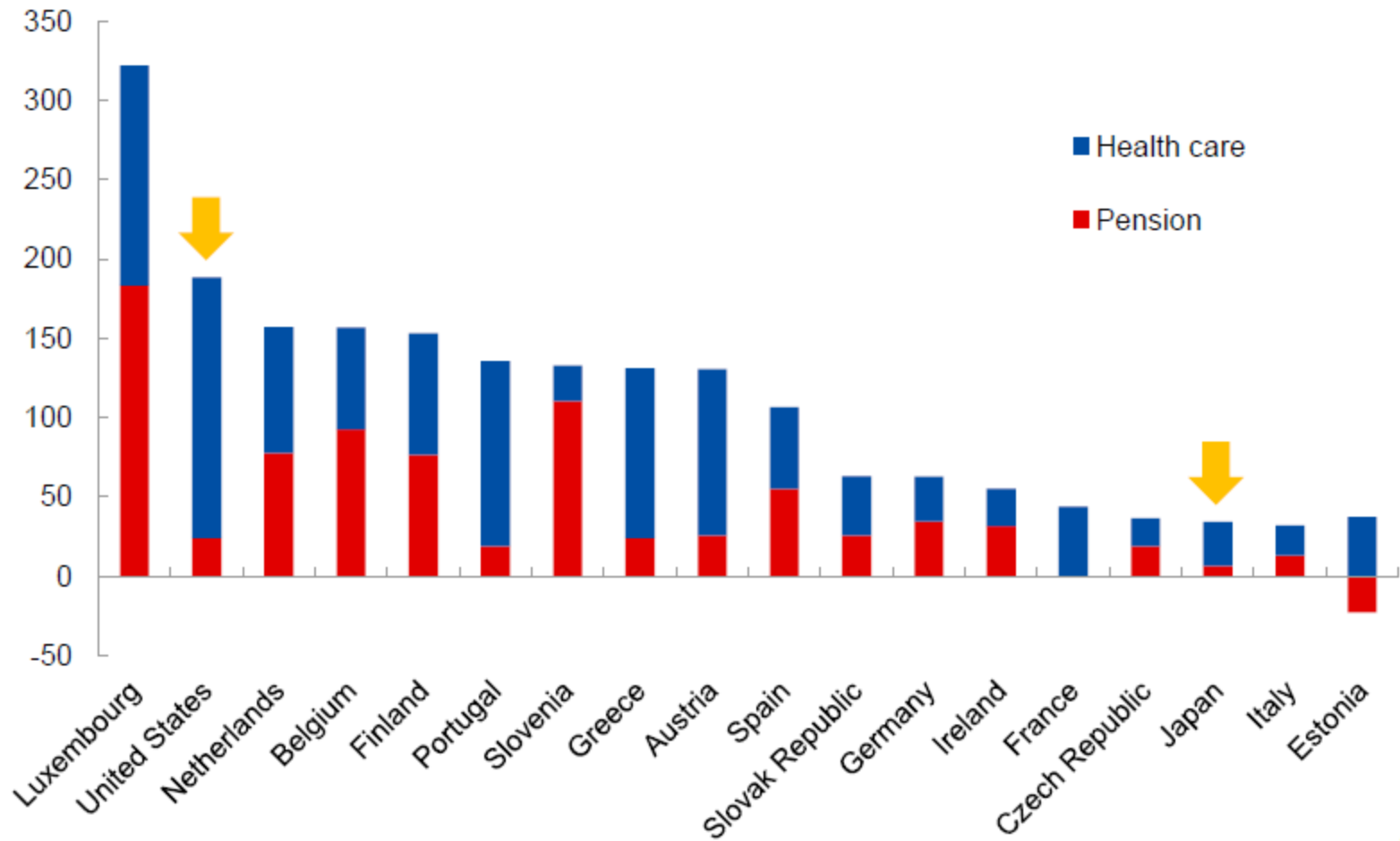
| | As per cent of potential GDP | | | | |
|-----------------|------------------------------------|---|---|--|-------------------------|
| | Underlying primary balance in 2010 | Underlying primary balance required to stabilize debt | Required change in underlying primary balance | Change in underlying primary balance in 2011 | Requirement beyond 2011 |
| | (A) | (B) | (C) = (B) - (A) | (D) | (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 |
| 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 |

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)



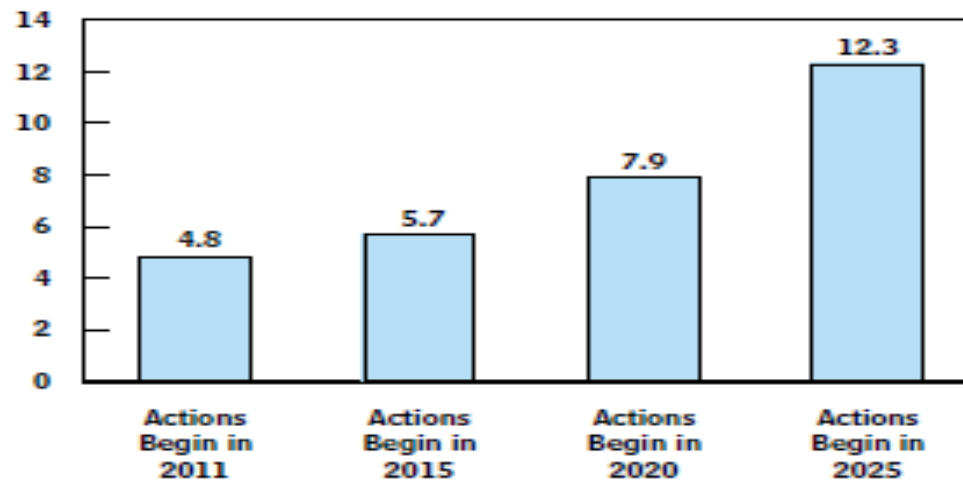
Need for early action

- 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

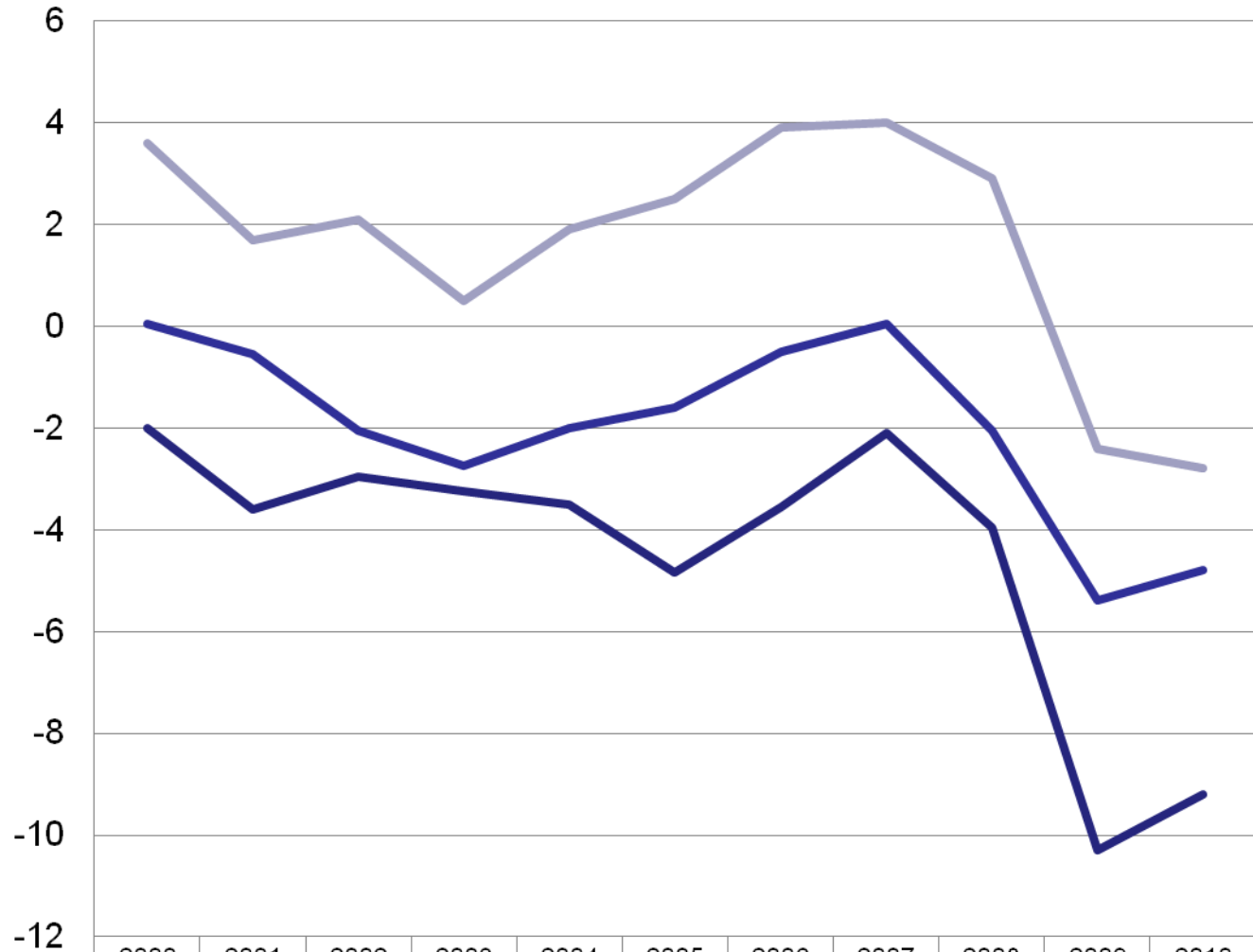
Political fallout following fiscal crises

- 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.

Deficit/Surplus as Percent of GDP



| | | | | | | | | | | | |
|------------------------|------|-------|-------|-------|------|-------|-------|------|-------|-------|------|
| Median Deficit Nations | -2 | -3.6 | -2.95 | -3.25 | -3.5 | -4.85 | -3.55 | -2.1 | -3.95 | -10.3 | -9.2 |
| Median OECD Nations | 0.05 | -0.55 | -2.05 | -2.75 | -2 | -1.6 | -0.5 | 0.05 | -2.05 | -5.4 | -4.8 |
| Median Surplus Nations | 3.6 | 1.7 | 2.1 | 0.5 | 1.9 | 2.5 | 3.9 | 4 | 2.9 | -2.4 | -2.8 |

Achieving the Politically Improbable

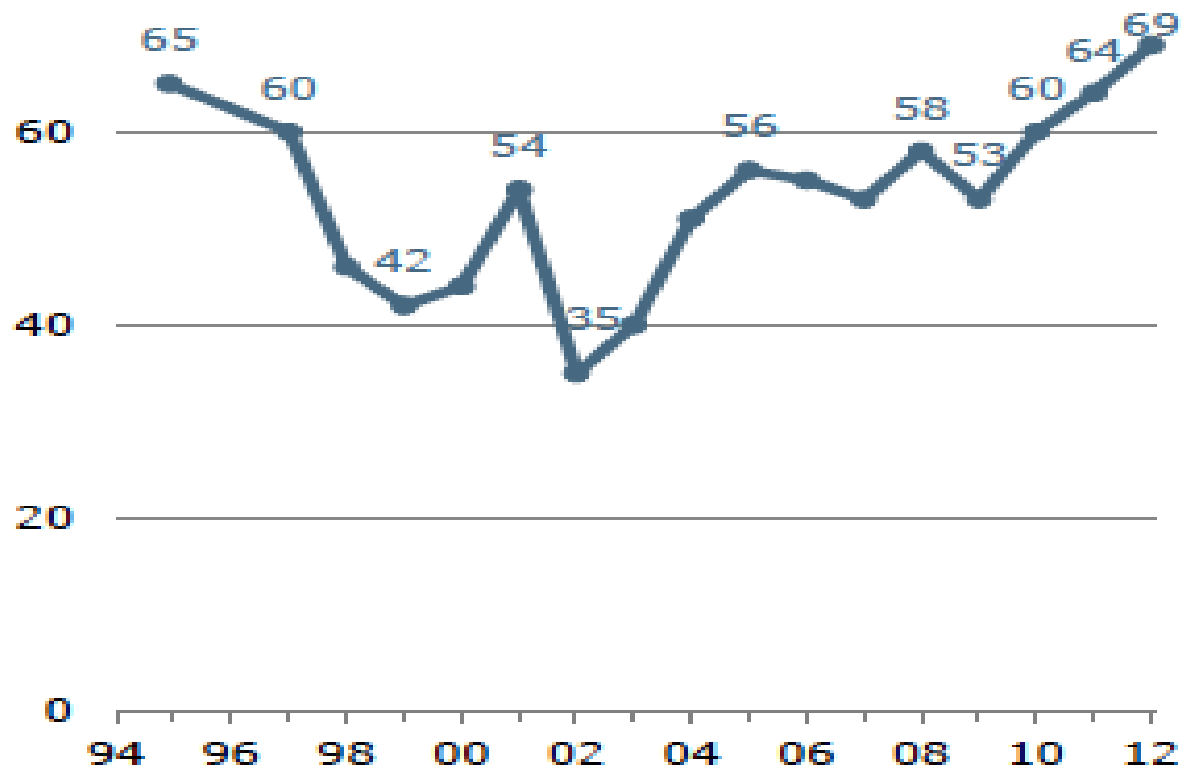
| Nation | Period | Fiscal Swing as %GDP |
|----------------|---------------|-----------------------------|
| Australia | 1992-2000 | 7.5% |
| Canada | 1992-2000 | 11.1 |
| Finland | 1992-2000 | 12.3 |
| New Zealand | 2000-2006 | 5.9 |
| Sweden | 1993-2000 | 14.9 |
| United Kingdom | 1993-2000 | 11.7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

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

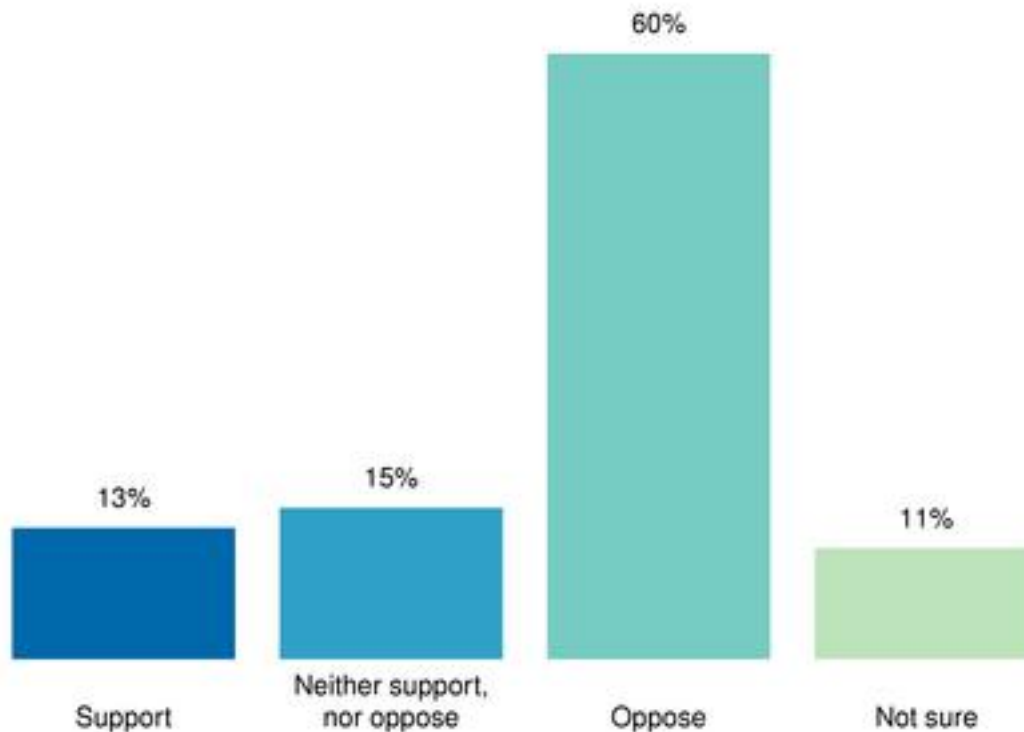
Deficit Concerns Climb

% who say reducing budget deficit is "top priority"

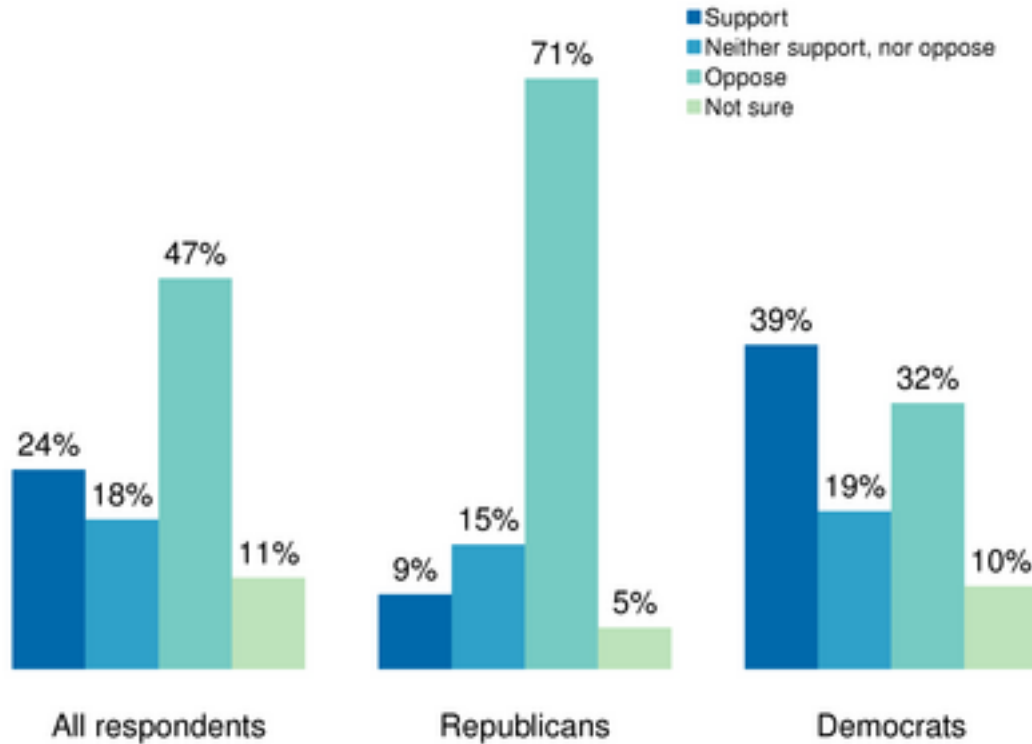


PEW RESEARCH CENTER Jan. 11-16, 2012. Q35b. From 1998 to 2001 question asked about "paying off the national debt" rather than "reducing the budget deficit."

Would you support or oppose a deficit reduction plan that included cuts to Social Security and Medicare?



Would you support or oppose a deficit reduction plan that included increased taxes?



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

| Scope/Method of mobilization | Narrow | Broad |
|------------------------------|-----------|----------|
| Interests | Pluralist | Party |
| Ideas | Expert | Symbolic |

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

