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Resolving Fiscal Imbalances: Does It Take a Crisis?

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Many nations in the Western world face nearly unprecedented fiscal challenges, both for the medium and longer term. The Great Recession has added to fiscal pressures and public debt to nations that are already beginning to experience the fiscal fallout from aging populations. Budgeting is clouded by nearly unprecedented fiscal ambiguity, as nations are conflicted between forces demanding fiscal consolidation and those advocating growth and stimulus to jump start stagnant economies.

Daunting challenges lie ahead in the next several decades for democratic nations and their leaders. With deficits and debt rising to near record levels in most nations, the recovery from the recession will still leave significant fiscal gaps that must be addressed. 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.

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The sustainability of national economies will ultimately require longer-term fiscal consolidation. The question that is now being raised is whether such actions are politically sustainable. Many in fact would conclude that fiscal consolidation is an unnatural political act – dooming governments to certain defeat in subsequent elections. Recent elections seem to bear this out, as governments have lost power in many OECD nations imposing fiscal austerity. Skeptical markets will rightly lose confidence in fiscal austerity regimes if significant questions cloud the political acceptability of nations' fiscal downsizing.

In fact, many analysts and observers have concluded that democratic nations will tend to procrastinate and adopt needed spending and tax reforms only when a market driven crisis arises to demand action. Yet, waiting for a crisis has significant downsides. Nations that wait for a crisis will face far larger fiscal adjustments. Moreover, the recent political unrest in European nations attests that implementing consolidation in the center of a crisis requires precipitous changes to be instituted in short order, causing untold political and social dislocation and risks to millions of people.

As the European nations begin to emerge from the recession, the central question will be whether democratic nations can take proactive leadership before a crisis forces their hand. The capacity of a democratic system to exercise fiscal self restraint and foresight are among the central questions facing advanced systems today. This paper addresses that question by examining the politics of fiscal consolidations in recent years, assessing whether and how leaders attempted to resolve the tensions between the fiscal and electoral imperatives.

The Case for Timely Action on Fiscal Challenges

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-timed fiscal consolidations have the potential to be self-defeating, prompting a vicious cycle of continued economic decline and short term fiscal erosion.

Ultimately, nations undertaking major fiscal cures in the throes of an economic crisis can usher in political instability. Unless they inspire a “contractionary expansion”, such consolidations can exacerbate both deficits and downturns, giving rise to public resistance and political unrest. The legitimacy of deep cuts is particularly vulnerable to reversal when governments introduce cuts with little advance public education or when consolidation is perceived to be externally imposed. Indeed, of the 14 European crisis-hit nations that had elections since 2009, nine of them deposed the sitting government.

Lessons Learned from Fiscal Consolidations

Notwithstanding the reigning pessimism about democracies and deficits, many advanced nations have in fact undertaken significant fiscal consolidations in recent years. One OECD study found that from 1978 through 2007, there were 85 fiscal consolidation episodes in 24 OECD nations that improved the cyclically adjusted fiscal balance. Most of these consolidation episodes were of short duration and led to only modest gains in fiscal balances. However, , several episodes lasted over longer periods and achieved considerably greater fiscal consolidation

Are there lessons to be learned from these previous episodes that can help budget officials cope with the wrenching fiscal choices today. Were the nations from the past able to definitively face structural deficits and resolve them in ways that were both economically and politically sustainable? Were the economies of those nations made better off not only in the short term but for the longer term? And were the publics of

those nations satisfied that fiscal consolidations were both equitable and economically efficient? As political leaders of today face seemingly no-win choices between austerity and growth, how did political officials fare with the voters when they implemented previous consolidations?

The quantitative research on fiscal consolidation can be helpful in answering these questions. In addition, it is informative to review the experiences of a set of nations that achieved significant consolidation and sustained surpluses for more than 6 years consecutively before the financial crisis. For purposes of this paper, five nations were examined – Sweden, New Zealand, Australia, Canada and the United States.

The Impetus for consolidation

Fiscal consolidation involves the allocation of sacrifice across contending groups and interests within each nation. Accordingly, it is not surprising that many nations require a compelling trigger to bring about deficit reduction. As a general rule, fiscal consolidation is undertaken only when public finances are weak, as measured by rising deficits and debt levels. In fact, some studies suggest that the gravity of the initial fiscal conditions influences nations to undertake deeper and more prolonged consolidations, which have a greater chance of stabilizing debt in the future.

Of course, deficits and debt do not by themselves cause a crisis by themselves – political actors do by using economic statistics to frame policy debates. Thus, in Canada, as the economy worsened, the crisis reached a boiling point when the nation's pride was wounded by a Wall Street Journal editorial likening the nation to a banana republic. In some cases, however, even relatively modest fiscal imbalances can lead to national alarm and fiscal consolidation. The labeling of these imbalances as a "crisis" in nations illustrated how that overworked term is often socially constructed.

In the United States, serious consolidation began in 1990 and lasted through 2001. High interest rates alarmed both the central bank and the business community but there was certainly no market crisis bearing down on the nation. Lacking a compelling market crisis, federal officials developed fiscal rules under the Gramm Rudman Hollings budget regime

in the 1980's, which threatened to impose across the board budget cuts of \$100 billion in 1990. Even without a crisis, the perceived political threat posed to President George H.W. Bush from the specter of these cuts and a slowing economy were sufficient to prompt him to renege on his campaign pledge to avoid new taxes.

Austerity and Economic Growth

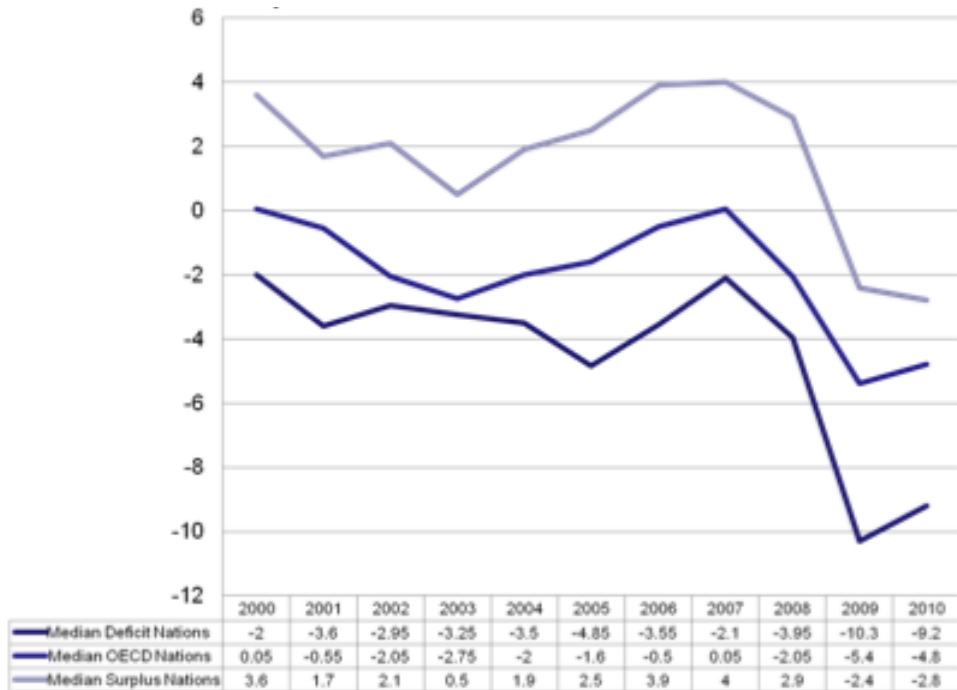
Considerable debate rages today about the alleged tension between fiscal austerity and growth. Certainly, macroeconomic theory tells us that economic downturns may be exacerbated and prolonged if major austerity is introduced at the low point of recessions.

Certainly, we have seen recently that many European nations have been forced by bond markets and the European community to initiate deep and painful consolidations at the bottom of the great recession. These nations paid the price for waiting until structural imbalances were revealed by market meltdowns in housing and financial institutions. These nations ultimately had to undertake consolidations to quiet restive bond markets, lest their interest rates rise to unsustainable levels, further slowing economic prospects and growth.

In contrast to the economic crisis hypothesis, in fact other nations undertake consolidation by waiting until their economies are beginning to emerge from recessions. Whether by forethought or fortuitous accident, leaders in some nations seem to have the uncanny ability to initiate austerity during what we will call a "goldilocks economy" – i.e. an economy that is not too good, but not too bad. In these times, deficit reduction can boost growth, partly by convincing central banks and markets to lower interest rates

Nations undertaking sustained consolidations reaped significant economic benefits over time. All five of our nations realized major improvements in interest rates, economic growth and lower levels of public debt. Sustained surpluses enabled these nations to survive the Great Recession with far greater resilience, with less crippling deficits and debt than others. As shown in Figure 6, the surplus group of nations lapsed into deficits averaging 2.8 percent of GDP by 2010, compared with 4.8 percent

for OECD as a whole and 9.2 percent for the nations with chronic deficits during the past ten years.



Importantly, well-timed consolidations offer political bonuses as well. Governments undertaking painful cuts and tax increases can point to tangible progress in economic growth to justify the programmatic and fiscal sacrifices. President Bill Clinton was able to do this in the aftermath of passing the 1993 deficit reduction legislation, as a growing economy gained new momentum on the way to a growth boom that lifted all fiscal boats.

The role played by political institutions

Political institutions are critical in determining whether and how fiscal consolidations will be shaped to respond to economic and fiscal triggers. Given the high stakes involved, a government must have sufficient political support to form an alliance with key groups and publics to push for needed reforms and retrenchment.

Among the political variables associated with consolidation, two stand out – the timing of consolidation and the relative strength of the ruling party. With regard to timing, there is strong evidence that governments are most successful when consolidations are introduced in the immediate aftermath of an election. In what has come to be known as the “honeymoon effect”, new governments have high standing with publics and are relatively untarnished by the slings and arrows of governing

The research is conflicted with regard to the impact of strong ruling parties on the prospects for fiscal consolidation. Some studies find that single party governments are more effective in forging agreements than coalitions. Strong majorities are associated with more decisive actions and more dramatic “cold showers” (Larch and Turrini, 2008). Strong parliamentary majorities are more likely to fashion lasting fiscal corrections and more fundamental reforms of major spending policies. Alesina finds that fiscal stabilization is facilitated by presidential systems with unified parties controlling the legislative branch (Alesina, Ardagna and Trebbi, 2006).

However, other research suggests that strong single party governments do not have statistically significant effect on consolidation performance (Wagschal and Wenzelburger, 2008; Sakamota, 2001). Countries with minority governments and coalition governments do as well as single party majorities. One leading scholar even suggests that single party majorities in parliamentary systems may be less likely to take on difficult policy choices than coalition or minority governments because of the singular concentration of blame on that one party. By contrast, divided governments facilitate hard choices by spreading blame to all parties and interests, assuming they can reach an agreement among themselves – a heroic proposition in some systems (Pierson, 1994).

There are times when national leaders succeed in gaining genuine bipartisan support for major reforms. This was particularly the case with

pension reforms. Given the political resistance to change in programs and structural policies, governments had incentives to reach out beyond their coalitions to form bipartisan or all-party commissions and task forces.

Consolidation strategies

The economic success and political sustainability of fiscal consolidation is shaped by the kinds of consolidation strategies adopted. On the economic front, considerable research has long supported the conclusion that successful consolidations are mainly expenditure based (Alesina and Perotti, 1995). One study found that expenditure cuts contribute 52% of successful consolidations compared to only 12% for unsuccessful ones (Von Hagen and Strauch, 2001). Spending consolidations are more likely to stabilize debt. Economists generally agree that spending cuts have less immediate impact on economic growth than tax increases. Moreover, spending cuts, particularly reforms to politically entrenched programs may signal to bond markets and savers alike the government's resolve to reduce deficits and debt over the longer term.

These general conclusions all depend on the timing and nature of tax increases and spending cuts. Recent studies suggest that revenue based consolidations can also be effective, particularly in low taxed nations (Larch and Turrini, 2008). Spain had revenue consolidations that were helpful. While revenue increases may be particularly counterproductive in weak economies, their impacts on stronger economies may be more salutary. Revenue-based consolidations can also be effective if tax increases are concentrated in more indirect taxes like consumption and excise taxes which have less growth dampening effects than increased taxes on income and investment (Tsibouris, et al., 2006).

A number of specific strategies were adopted by nations reviewed in depth to mitigate the imposition of losses from budget cuts and tax increases:

- Sharing sacrifice through such strategies as across the board cuts and balancing spending and revenue actions.

- Compensating losers with packages that cement coalitions by providing gains to offset a portion of the losses of major groups..
- Phasing in cuts by making wedge shaped cuts that grow over time.
- Promoting larger, more sweeping changes improve chances for dramatic gains in economic outcomes and help promote perceptions of fairness by spreading the pain across more stakeholders.
- Taking the window of opportunity provided by consolidation to usher in long-term reforms in spending and tax programs.

Fiscal Rules

During times of fiscal austerity, as the stakes involved with budget decisions grow, formal rules and structures became more essential for budgeting. Fiscal rules can serve as a useful adjunct to 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.

Research on fiscal consolidations is mixed, but most show that the coverage and strength of fiscal rules helps promote consolidation. One study suggests that balanced budget rules are more important than expenditure rules (Debran, et. al., 2008). Another study suggests that budget balance requirements enable a more balanced focus on both revenues and spending (Larch and Turrini, 2008). Yet, other studies find that balanced budget requirements can produce procyclical decisions and be evaded by classifying various activities as off budget (Anderson and Minarik, 2007).

However, it is important to place fiscal rules in perspective. 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 (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 that created them – which constitutes both strength and a weakness (Meyers, 2009).

Political Outcomes

When 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

Similarly, the nine OECD nations running persistent surpluses running up to the Great Recession achieved surprising political success. The governments in the nine elections were reelected in 63 percent of the 24 elections in the eight years prior to the Great Recession. By contrast, nations with the highest deficits during this year were reelected 40 percent of the time. More importantly, the governments in surplus nations had far greater success in elections following the Great Recession. Incumbent governments won in 6 of 8 elections in the surplus group, but only won in one of the 5 elections in the deficit group.

Voters appear to reward leaders who make a convincing linkage between budget cuts and the economy. 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.

Conclusions

Western nations and budget officials are condemned to navigate in churning fiscal waters, caught between the Scylla of economic recession and the Charybdis of fiscal austerity. The real question is whether democratic nations can take proactive leadership before a crisis forces their hand. 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.

Nations that are currently in crisis have no choice but to undertake economically and politically destabilizing actions to maintain some semblance of credibility with vital bond markets, in the absence of a bailout from supranational institutions. However, when those crises abate, those nations can and must observe the lessons from nations discussed in this paper which exercised foresight to take early action on incipient fiscal pressures and challenges. While the temptation will be strong to celebrate and share in the benefits of national economic renewal, it should be remembered that the seeds of the next fiscal crisis are often planted during these periods when new structural fiscal commitments can be disguised by burgeoning short term growth.

The experiences of nations with long periods of fiscal balance and surplus show the rewards that accrue from early action on incipient fiscal challenges. Far from causing economic and political meltdowns, this paper shows that timely and proactive fiscal reforms can not only achieve sustainable economic and fiscal outlooks but also promote favorable political outcomes for leaders. These nations are far better positioned both for short term shocks such as the Great Recession as well as long term

fiscal challenges stemming from the demographic, health care and economic changes underway.

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