Will it Take a Crisis?

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INTRODUCTION

The United States, along with most advanced nations, faces nearly unprecedented fiscal risks, both for the medium and longer term. The Great Recession prompted deficits to escalate to over 10 percent of the economy, the highest ever in our peacetime. Recent deficits are a prelude to an even more daunting long-term fiscal outlook. An aging population and rising health care costs will, in the absence of policy changes, send the budget into a tailspin, with deficits and debt rising to unsustainable levels that would eventually cause an economic shock. Our standards of living would assuredly decline and the precipitous policy changes necessary to rescue the nation from economic meltdown would cause lasting damage to the political fabric of the nation.

Herbert Stein long ago suggested that if something is unsustainable, it will stop. But there is a corollary—how it stops matters. Will these trends be reversed through a gradual process brought about by policy interventions or by a rude shock caused by economic forces over which we will have little control? Bringing about a more sustainable fiscal policy calls for early action that will pay dividends by addressing the growth of debt before it requires hasty actions in the face of an economic, social or ecological crisis. Moreover, if started early enough, needed changes in spending and taxes can be phased in gradually, permitting people and businesses time to make adjustments in their own plans and expectations.

The alternative is an unavoidable crisis, which will cause harm to current and future generations. Such a crisis would force policy makers to make far more painful and precipitous policy changes than are required to meet the challenge now. Such a so-called "hard landing" has in fact occurred in other nations. Restive financial markets will lose confidence in fiscal and economic management, causing a flight of foreign investment, significant currency depreciation and interest rate increases. Governmental leaders will be forced to undertake major spending cuts and tax increases in very short order in desperate attempts to restore the confidence of markets. Policymakers would not have the luxury of gradually phasing in wrenching changes to entitlements and taxes, but would instead have to reach for major changes that reduced fiscal deficits quickly.

Accordingly, one of the central questions facing our system and those of other advanced nations dealing with similar fiscal outlooks is whether a democratic nation like ours can take proactive leadership before a crisis forces our hand. Many would question the political wherewithal of the United States to respond to such challenges with early and timely action. The electoral imperative is viewed as being at odds with the fiscal responsibility imperative—political leaders have few incentives to call for sacrifices, and many reasons to delay addressing long-term problems or for denying they exist. In this view democratic leaders will only take action when crisis forces their hand.

The midterm elections ushered in divided government once again which has only seemed to reinforce the pessimism about our system's capacity to solve vexing fiscal challenges. During the same period, three separate commissions issued reports laying out roadmaps for resolving the nation's fiscal deficits through packages of tax increases, spending cuts and budget process reforms. [1] Many are asking whether a more divided national government will have the capability to act on the fiscal reform agendas recommended by these commissions.

Does our democracy have the capacity to exercise the fiscal self restraint and foresight necessary to head off a certain fiscal and economic storm? Or are we doomed to wait for the painful economic shock that would exact social, political, and financial costs on the nation for years to come?

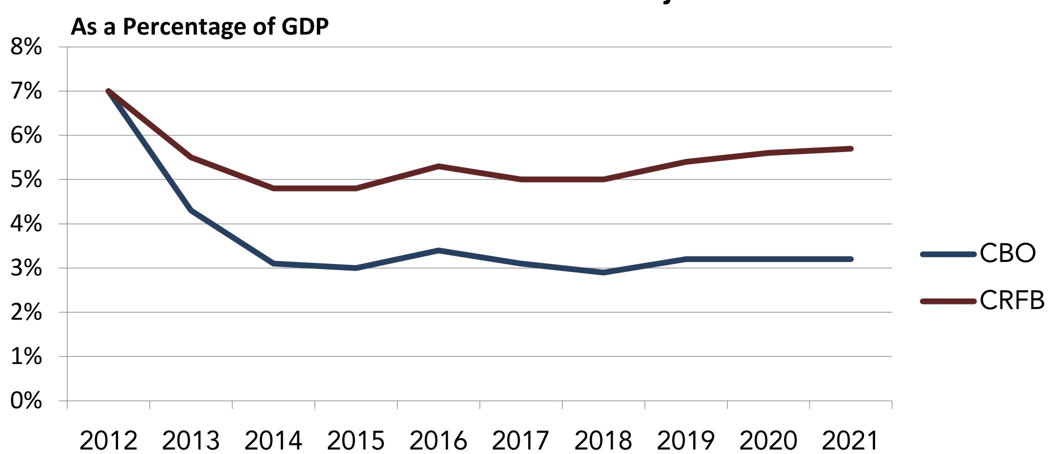
This paper considers those critical questions. After reviewing the magnitude and threat of our fiscal imbalance and surveying the crisis hypothesis, it demonstrates how some democratic nations have in fact addressed fiscal deficits in recent decades, and how the political leaders who championed fiscal change achieved broad support and re-election. The paper also identifies some of the factors that can prompt policy makers to undertake fiscal reforms, including such elements as public opinion, economic markets, norms and fiscal rules. Finally, we assess the political prospects for the United States to avoid a fiscal and economic meltdown through deliberative democratic processes.

THE FISCAL THREAT

Daunting challenges lie ahead in the next several decades for the United States and other major democracies. We face both a shorter- and longer-term fiscal gap that, absent policy changes, will grow to become the largest deficits and debt experienced in our history.

While current deficit levels will come down as the economy recovers, the federal government is nonetheless likely to face deficits approaching 6 percent of Gross Domestic Product (GDP) by 2021, according to the "realistic policy" baseline of the Committee for a Responsible Federal Budget.[2] Figure 1 displays this scenario as well as the CBO "current law" baseline, Unlike the current law baseline, the realistic baseline is based on more plausible budget outcomes like the continuation of expiring Bush tax cuts, AMT exemptions, current Medicare doctor fee schedules, and various discretionary spending adjustments.

Figure 1: 10 Year Budget Outlook:
CBO & CRFB Deficit Projections

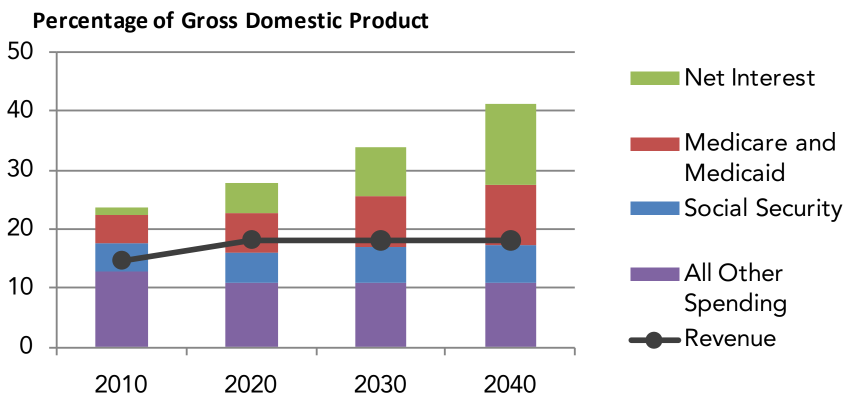


Source: Congressoinal Budget Office and the Committee for a Responsible Federal Budget

The publicly-held debt would reach 90 percent of the economy by 2021, using the CRFB realistic baseline. Even after the economy returns to full employment, a longer-term structural deficit would remain, reflecting the systematic growth of key entitlement spending programs and the failure of current revenues to keep up with their accelerating growth.

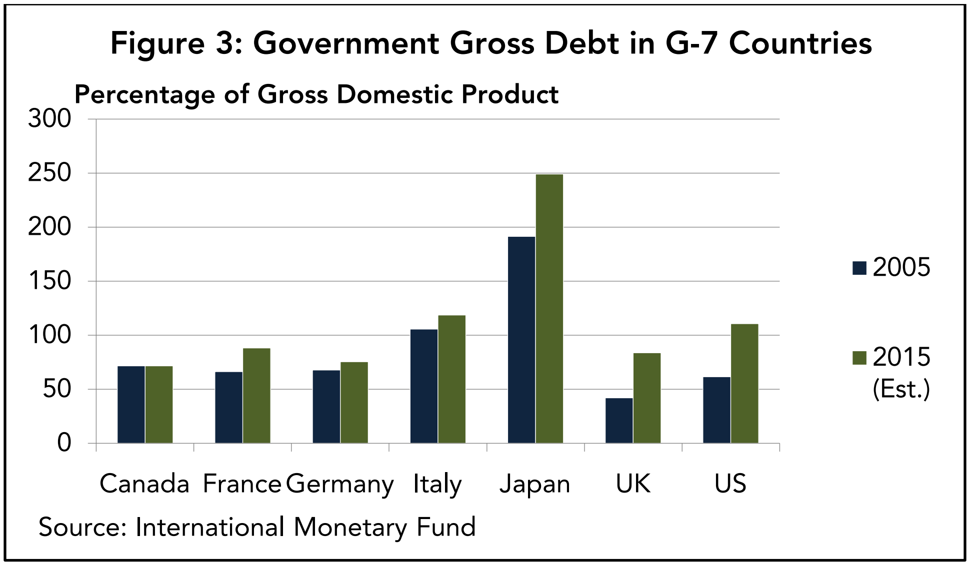
As the baby boom retires and health care costs continue growing at exponential rates, deficits and debt explode to economically unsustainable levels. The Government Accountability Office long-term budget model shows that deficits approach 20 percent of GDP in little more than two decades under a scenario resembling the projections by the Committee for a Responsible Federal Budget.[3] Over this period, interest payments on the federal government's accumulating federal debt exceed 8 percent of GDP—making it the largest single expenditure in the federal budget.

Figure 2: GAO Long-Term Budget Simulation, Alternative Assumptions, Fiscal Years 2010 - 2040



Source: Government Accountability Office Simulations

We are not alone. The near- and long-term fiscal challenges facing us afflict many advanced nations. The Organization for Economic Co-operation and Development (OECD) nations saw their deficits spike from 1.2 percent of GDP in 2007 to a level approaching 8 percent of GDP in 2010. The International Monetary Fund (IMF) shows the trends in public debt across advanced nations in the G-7, through 2015.

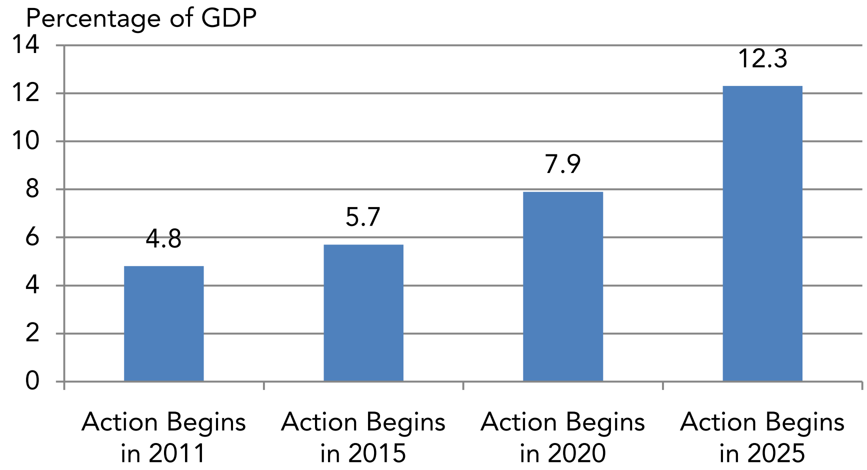


Consequences

The effects of deficits are well known but they bear repeating here. Large deficits reduce national savings, leading to higher interest rates, more borrowing from abroad and less domestic investment, which in turn serve to lower income growth. While borrowing from abroad can help finance investments, future living standards are lowered because more of our income has to be devoted to servicing foreign debts. Growing debt also crowds out other spending priorities. Interest on the debt is the ultimate mandatory spending item and has first draw on the national treasury before battleships and Social Security. As interest grows with higher debt and interest rates, our ability to finance emerging priorities and respond to future wars and downturns becomes progressively constrained.

Delay in facing these challenges exacts major costs on the nation. The inevitable fiscal consolidation initiatives needed to close the fiscal gaps would be larger for every year that the nation does not take action. The chart in Figure 4 illustrates how delay increases the size of the fiscal gap that must be resolved, based on CBO data. [4]

Figure 4: The Cost of Delay: Reductions in Primary Spending or Increases in Revenue Needed to Close the 25-Fiscal Year Gap under CBO's Alternative Fiscal Scenario



Source: Congressional Budget Office Long-Term Budget Outlook, June 2010

These escalating gaps are partly a function of the growth of interest costs. As deficits and debt grow during years of no action, interest costs escalate in the budget, prompting even higher deficits and debt in a vicious cycle. In addition, higher deficits over longer periods of time gradually reduce economic growth and push up interest rates, again contributing to a vicious cycle where deficits and slow growth become mutually reinforcing.

As debt grows as a share of the economy, the United States may very well be more vulnerable to an external market shock. Leonard Burman, a leading public finance scholar and former public official, has suggested that we might be setting ourselves up for a "catastrophic budget failure" in which financial markets lose confidence abruptly, forcing a spike in interest rates stemming from investors' fears of a default or monetization of the debt. Even if this does not give rise to default, the economic and political price that our nation would pay in the form of inflation, possible currency free fall and recession would constitute a crisis. [5]

It is unclear whether such abrupt market reactions are in the cards in the United States. The Treasury has become more reliant on foreign investors and central banks to finance federal debt, with foreign ownership now constituting 50 percent of publicly-held and traded U.S. Treasury securities. In some respects, these investments in our economy have been a source of strength, permitting higher investments with lower interest rates than would have occurred with the meager domestic savings of Americans alone.

However, some have expressed concerns that as the levels of federal debt continue to grow, approaching 100 percent of the economy in the next 10 years, foreign investors may get nervous about their financial positions. Worried about prospects for the erosion of the value of their holdings, these investors might shift their investments to other nations and assets. This would cause the value of the dollar to decline and force higher interest rates to attract a diminished pool of savings from other borrowers.

It is likely that this disinvestment would occur through a gradual process where foreign owners would diminish their holdings of new treasuries. A rapid sell-off of existing stocks of assets would likely cause as much harm to foreign-held asset portfolios as they would to the United States debt finances and economy. Moreover, many economists argue that, over the longer term, a withdrawal of some foreign investors such as Chinese or Japanese central banks would attract other foreign investors to treasury securities, prompted by the rise in interest rates that such a withdrawal would trigger. [6]

Today, the United States has important international economic advantages that continue to make our governmental and private financial assets attractive relative to other places to invest. Such advantages include stable political institutions, liquid markets and good relative rates of return. In the case of treasuries, the influx of foreign investments in government bonds during the recent global downturn reaffirms the confidence the international markets have in the underlying safety and soundness of federal finances. Moreover, unlike other nations, the federal debt is denominated in dollars. Countries like Mexico and Argentina experienced a vicious circle when currency devaluations increased the costs of paying foreign denominated debt.[7]

Paradoxically, the global financial strength of the United States may ultimately constitute a weakness. Simply put, we have the capacity to weather high levels of debt that may bring other nations to the brink of a loss of investor confidence and a subsequent economic meltdown. Carmen Reinhart and Ken Rogoff observe that many nations with weak economic underpinnings default at debt levels below 60 percent of their economy.[8] Lacking the dramatic signals of a crisis, we may in fact be able to muddle through at relatively high levels of deficits and debt for years to come.

Waiting for a crisis before we begin serious fiscal actions and reforms would force the nation to go through years of slower economic growth in the wake of higher interest rates and current account deficits stemming from years of reliance on foreign-held debt. Moreover, the flexibility to respond to emerging needs or other crises would be severely curtailed as interest costs grow inexorably to crowd out other budgetary priorities.

While the prospects for an external financial crisis are likely far off, policy makers ignore the potential for a major market shock at their own peril and that of the nation as a whole. While such an event may appear to have low probability now, the large consequences should inspire precautionary action by policy makers. Perceptions of investors are vulnerable to changes over fairly short periods of time, as the recent downfall of major investment banks has proven. Other nations have shown that when an undefined but nonetheless real "tipping point" is reached, markets can suddenly lose confidence in the safety and stability of current or future governmental and private economic finances. The best way to ward off a hard landing would be to take action now to phase in a sustainable policy path through spending and tax changes before a crisis.

EROSION OF FAITH IN DEMOCRATIC INSTITUTIONS

Notwithstanding the overwhelming advantages of early action on fiscal challenges, 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.[9] 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 20 years from now. Allan Drazen and William Easterly conclude that the hypothesis that a crisis is necessary to induce significant reform has become the new orthodoxy.[10]

In the United States, this dour outlook has been voiced by some of our leading fiscal observers. Leonard Burman has concluded,

> "The basic problem is that policy makers 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."[11]

Incentives and Interests

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 demonstrate how bureaucrats and politicians alike will force government budgets to be higher than they should be to increase their own "political incomes."[12] 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.[13] Buchanan and Tullock argue that politicians are incapable of fixing the deficit. Elections make them shortsighted and irresponsible and only a major crisis or constitutional amendment will force fiscally responsible actions.[14]

Beyond public choice theory, other political scientists have long observed that an asymmetry of influence exists between those reaping the 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. Moreover, efforts to unwind these programs are undermined because those bearing the concentrated costs of cutbacks have greater incentive to voice their concerns than do broad publics who stand to realize diffuse gains.[15] This asymmetry of interests causes a deficit bias—the most intense interests with the greatest incentives to mobilize are the narrow groups benefiting from higher spending or lower revenues, not the broader publics who have to finance the costs in one way or the other.

The interest group system institutionalizes this bias enjoyed by narrow interests. Economists like Mancur Olson argued that interest group coalitions come to dominate policy areas in advanced nations and have incentives to impose inefficient policies on broader-based populations who don't have sufficient incentives to mobilize as interest groups. Ultimately, he theorized that advanced nations will experience economic decline in the grips of these self-interested cartels.

The interest group bias is further accentuated by the politically self-reinforcing dynamics triggered by existing public policy programs and commitments. As framed by Paul Pierson, social welfare programs breed "path dependency" which serves to mobilize political action by recipients supporting current benefits and opposing reforms and reductions to those programs. He concludes that the political mobilization and organization of beneficiaries and providers makes a frontal assault on the welfare state "politically suicidal" in most nations.[16]

Accepting fiscal sacrifice is fraught with risks for political officials and groups. The classic prisoner's dilemma game describes the situation faced by groups asked to give up benefits in deficit-reduction initiatives. This game acquires its name from the dilemma facing two prisoners who conspire to commit a crime (see Table 1).

Table 1: The Prisoner's Dilemma

A/B	Cooperate	Defect
Cooperate	0/0	2/0
Defect	0/2	1/1

When apprehended and questioned separately, they may wish initially to cooperate with each other—all they have to do to escape punishment is cooperate in a story covering up their crime. As the table shows, cooperation by both with each other in the cover-up would free them from serving any jail time. But while there are rewards in cooperation, there are risks—each would face the highest penalty of two years in jail if they continued the false story while the other confessed. As a result, they both confess, and each spends one year in jail due to their mutual fear of being exploited by one another.

This same logic applies to budgeting. Groups and agencies that may support the overall goal of fiscal balance will be reluctant to volunteer fiscal sacrifice out of fear of being exploited by other competing groups who might fail to reciprocate. In budgeting, as in other areas of our lives, no good deed goes unpunished!

Institutional Barriers

Traditionally, most observers of our system would conclude that the checks and balances in our system discourage major policy change and fiscal sacrifice. Traditional models of policy making are generally based on the twin principles of incrementalism and negative feedback.[17] 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.

The Madisonian system's checks and balances reinforce a system where major change must overcome numerous hurdles, sometimes called veto points. Major changes that occurred were viewed as principally orchestrated by strong presidents with cohesive party support, and even strong presidents at times 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.[18]

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. In some respects, recent changes in policy making and budgeting in the United States have reinforced the potential of the system for gridlock and stalemate over major changes.

Members of Congress and presidents have become more focused on fundraising, fence mending and other activities in districts and less attentive to working together to craft national policy solutions to vexing challenges, regardless of policy area. David Mayhew chronicled the consequences for national policy making: 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.[19] Even though most sitting members of Congress can depend on being reelected, they feel "unsafe at any margin," in the words of Thomas Mann. [20]

As the primary system has become the dominant model for nominations across the nation, members of Congress must be increasingly sensitive to the positions of the more ideologically extreme factions within their parties who dominate turnout in primary election contests. The median voter that has traditionally been posited as being in the forefront of political leaders' calculations in position taking in Washington policy making is now being supplemented or even supplanted by the median primary voter—a far more polarizing force that arguably accentuates the incentives for gridlock and stalemate in policy formation and leadership in Washington. Accordingly, the past 40 years have 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.

THE ROLE PLAYED BY CRISIS

From these perspectives, a crisis is said to be necessary to instill the requisite urgency and commitment to change. This "crisis-reform thesis" is predicated on the notion that reform of any kind is politically improbable at best. Current policies and institutional arrangements are embedded in laws, protected by dominant coalitions and sustained by habituation and organizational inertia. Although it may be possible to smuggle in reform through a series of cumulative, incremental policy adjustments, this is a time-consuming, easily reversible and potentially drifting process.[21]

A crisis works its political effects through several pathways. First, it discredits existing policies and the leaders who champion them. A crisis can also engender urgency and fear that can be productive of quick action. New policy outlooks and frames can quickly garner consensus, demobilizing and delegitimizing any opposition. As we saw with 9-11, major crises can sweep across many policy arenas and facilitate a more strategic system-wide response, culminating in such actions as the creation of the Department of Homeland Security. [22]

A crisis can also overcome the public choice challenges discussed above. 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. 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.[23]

Indeed, in our system, every interest group attempts to portray their concerns as reaching a crisis stage, whether it is the "national epidemic" of obesity or the "quiet crisis" in public service. If we followed the hyperbolic rhetoric of our policy process, every issue would constitute a crisis, thereby depriving the concept of analytic meaning.

Some may be tempted to deploy hyperbolic crisis rhetoric to mobilize public support to address the deficit. Comments by officials of creditor nations such as China about the U.S. economy are seized upon as alarming portents of dire fiscal outcomes waiting just around the corner. Drawing analogies with Greece and other fiscally challenged European nations is another example of attempts to simulate a crisis through the use of metaphors and analogies, whether appropriate or not.

For purposes of this paper, a crisis is defined as an exogenous event or, "shock," bearing down on all actors of the system that requires some kind of policy response. In its pure form, a fiscal crisis would consist of a market induced shock where credit markets react to our fiscal policies by actions that cause immediate harm to our economy and to the prospects of financing government debt.

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. It may be that our nation might respond

Box 1: Social Security Reform of 1983

One of the most important policy reforms of the past 30 years was the reform of the Social Security program engineered in 1983. While commonly viewed as politically difficult, policy leaders came together across the ideological spectrum to achieve major changes in benefits and taxes, putting the program on more sustainable footing. The singular force prompting action was the impending exhaustion of the Social Security trust fund—an event that would lead to cuts in benefits for current retirees.

Under the commission, this impending "crisis" forced an unlikely agreement between President Reagan and Democratic Speaker Tip O'Neill, immunizing both parties from the political fallout. This crisis was, however, an endogenous one that was fully controllable by political leaders. Unlike an externally driven market crisis, this one could have been deferred through the joint actions of the president and Congress. They could have worked together to override the trust fund insolvency by injecting general revenues or provide additional internal debt to defer the need for benefit changes. Indeed, such actions have occurred recently with the highway trust fund, whose impending exhaustion was deferred with a general fund bailout.

to endogenously defined or contrived crises. Should this occur, it would not illustrate the impact of a crisis on political decisions, but rather the influence of artfully drawn rhetoric and symbolic arguments on those decisions. Box 1 provides an example of the use of endogenous crisis to reform Social Security in 1983.

It is recognized that the line between exogenous and endogenous crises is more of a continuum than an on-off switch. For instance, as will be discussed below, the deficit reduction achieved in 1990 could be said to fall between these two concepts. A Democratic Congress and Republican President George H.W. Bush were forced to reach agreement by the impending "crisis" forced by the spending cuts required by the reigning Gramm Rudman Hollings law, as well as by pressures from the bond market and Federal Reserve threatening higher interest rates. While national leaders portrayed these events using crisis metaphors, these same leaders had previously sidestepped the same statutory budget constraints that were now said to be forcing their hand. The pressures exerted by markets still were prospective and could not be said to constitute an exogenously defined market event that forced the hand of national leaders. Those policy makers intent on taking action nonetheless were able to cleverly utilize these pressures to define a crisis environment justifying politically difficult action. This suggests that successful reforms achieve political support partly by expropriating the language of crisis to create a compelling case for action now, regardless of whether a true exogenous crisis in fact exists.

Fiscal Crises: The Failure of Democratic Politics

In the area of fiscal policy, other nations have experienced the cruel but necessary discipline that exogenous market crises can induce. According to one estimate, more than 90 nations have in fact defaulted on their debt over the past two centuries.[24] 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.

Argentina offers a classic example of how a financial crisis and debt default unfolds against the backdrop of a nation with overextended commitments. In the face of signs of inflation and unsustainable levels of national debt, national leaders hesitated in instituting fiscal adjustments, delayed rolling out an economically sustainable exchange rate regime, postponed debt reduction and avoided other hard choices.

With a fixed exchange rate and growing reliance on foreign investors, Argentina experienced a vicious circle in 2001 when investors lost confidence and precipitated a collapse of the currency and financial markets. Facing repayment with rapidly depreciating pesos, Argentina defaulted on over $155 billion of public debt, confronting an economic meltdown with 25 percent unemployment, a banking crisis and rapidly escalating budget deficits. As the president resigned, national leaders implemented significant and rapid budget cuts to bring debt down to proportions that could be financed with their newly devalued currency.[25] Pension funds and state salaries were cut, and the government required the conversion of all private pension assets into government bonds and loans to service debts. Since that time, Argentina has made significant progress, led by a boom in exports and favorable terms of trade.[26]

Other more developed nations experienced pressures from international markets that caused major economic and fiscal shifts. While avoiding outright default, the measures these nations had to take to restore investors' confidence constituted radical and painful medicine imposed during a time of economic decline and hardship.

New Zealand, for instance, instituted major economic and fiscal reforms in the mid-1980s that transformed one of the most socialized countries in the world into one of the least regulated economies. With persistent deficits approaching 6 percent of the economy, the nation experienced virtually no growth, high inflation and a loss of investor confidence, leading to a large currency crisis that forced the government's hand.

Whenever it happens, an external market shock and crisis imposes painful adjustments on governments. Much-delayed changes have to be implemented abruptly with little deliberation or debate (see Box 2 on New York City financial crisis). In the case of our national budget, if faced with a

Box 2: New York City Fiscal Crisis

The most recent case of a government in our own nation experiencing a market shock and default is New York City. In 1975, after years of paying for its services through short-term debt, the city faced a fiscal shock when the private markets refused to loan New York City any more funds. In addition to having to repay huge amounts of debt, the city had to make dramatic cuts in city personnel, schools, and public health services—cuts that had to be implemented in a matter of weeks. The city was forced to institute cuts that caused layoffs of nearly 15 percent of police, fire and sanitation workers. New capital investment evaporated at a time of economic slowdown and social unrest. New York City was forced to hand fiscal control over to the state and borrow from the federal government. The city was on the brink on filing bankruptcy in court, but a last minute infusion of cash from pension funds staved off the crisis. New York City did not have full control of its finances until the mid to late 1980s.

market-induced shock, it is likely that major deficit reduction initiatives would have to be undertaken in short order to appease global credit markets. Almost certainly, this would entail making precipitous changes to entitlements and tax benefits that have become engrained in our economy and social expectations, perhaps overnight.

As noted earlier in this paper, the current relative strength of the American economy and the dollar in global finance means that a market-driven external crisis is a far more remote engine of fiscal change here than for many other nations, although the consequences would be much more severe. Thus it becomes incumbent on our national community to examine whether a nation like ours can be motivated to achieve major fiscal and policy reforms through other avenues beyond a crisis.

ACHIEVING THE POLITICALLY IMPROBABLE

Notwithstanding the reigning pessimism about democracies and deficits, many nations have in fact undertaken significant fiscal consolidations in recent years. Many did so in the absence of a major market driven crisis.

During the past three decades, there were 14 episodes in advanced economies and 26 in emerging economies when individual countries improved their structural primary balance by more than seven percentage points of GDP. [27]Several economies also were 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 is possible but will no doubt be difficult.[28]

Economist Henry Aaron noted that many advanced nations have achieved even more significant swings in the primary balance in recent years. Table 2 illustrates that many nations have achieved significant and sustained reductions of deficits and debt including the United States.[29]

Table 2: Deficit Reduction Achieved in Selected Nations

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. While several of these nations did face pressure from credit markets, many undertook fiscal reforms and cutbacks due to internal political and economic pressures in the absence of an externally defined market crisis.

Public pension reforms also emerged during the past 20 years as a major thrust of fiscal and social policy making in OECD nations. With populations aging more rapidly than the United States, pension reform became a major agenda item that nations turned to, sometimes while engaging in broader fiscal retrenchment efforts.

One senior observer, Kent Weaver, noted that the extent of worldwide reforms in Social Security has been "simply extraordinary."[30] With older populations and more enriched benefit packages, other nations engaged in public pension reforms as a high priority. Common strategies included increases in retirement ages, shifts in benefit indexation to lower growth, providing incentives for later retirement and reducing benefits to higher-income people.

John Myles notes that the pension reform movement is an example of policy foresight in action, as nations undertook reforms years ahead of when they absolutely needed to.[31] The impetus for reform came not from the nations with highest costs, but often from those with only modest benefits and cost structures, including the United States. Some nations, such as Sweden and Canada, opportunistically seized on broader fiscal pressures as a rationale for reforming pensions, even though such systems were not facing immediate financial shortfalls.

In the United States, the National Commission on Social Security Reform (known as the Greenspan Commission, after its chair) developed a political consensus for reforms to Social Security in 1983 stemming from the exhaustion of the program's trust fund. 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. The bottom line was well stated by the IMF. Without reforms, pension spending would have increased from seven to 10 percentage points of GDP in the next 20 years in the G-7 economies. The adoption of pension reforms succeeded in containing the projected increase to one percentage point of GDP.[32]

Major Policy Change in the United States

In studies of policy reforms in the United States over the past several decades, major reforms have been instituted in the absence of a major crisis across many policy areas including fiscal policy.

Widely noted shifts in our political institutions created greater opportunities for new issues and interests to take root. In the United States, 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.[33] The media presence in policy making 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. 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. In Box 3, major policy reforms are listed that have passed in the last three decades. As noted, most of these changes were not precipitated by crisis but rather by political leaders capitalizing on the emergence of new ideas and interests vying for national attention.

Box 3: Explaining Policy Reform

New theories of political science recognize a far greater role for ideas in policy making than older pluralistic theories grounded in the politics of interest groups. 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 several scholars have characterized as four "pathways to power": pluralist, partisan, expert and symbolic.[76] In this model the four pathways to power are 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 the following table:

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.[77] 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 partisan pathway has traditionally been conceived as the major way in which broad-based change is ushered in to our system, party leaders have episodically been able to mobilize broad publics to outflank and shift the framing of issues away from the narrow confines of pluralistic bastions. The budget reconciliation process and discretionary spending caps, for instance, were tailor-made to reinforce the partisan pathway by giving leaders a mechanism to develop omnibus budget packages and enforce budget discipline that might not survive in the pluralist realm of the individual committees and their interest group allies.[78]

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. When issues fall into the expert pathway, professional knowledge and technical feasibility become the source of legitimacy against which all proposals are based. Timothy Sinclair has argued, for instance, that fiscal experts have persuaded policy makers in many OECD nations to embrace fiscal discipline and the so-called "deficit discourse" as the reigning public philosophy of the day.[79]

The symbolic pathway can also generate rapid change, as 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.

Often, many "inside" pundits opined that these reforms could never happen because they offended too many entrenched interests. The tax reform of 1986 was a particular surprise, overcoming the resistance of highly organized interests on tax policy issues, what some would call "Gucchi Gulch." Theories about policy making had to race to catch up with what amounted to a far more volatile and open process than many academics and observers would have predicted. (See Box 4 for discussion of emerging theories of policy change).

Box 4: Crisis and Policy Reforms: 1981-2010

This table was developed by the author based on all of the major policy reforms enacted in the past 30 years across major policy areas. Policies chosen were those where major changes were ushered in causing reductions or shifts in policy benefits previously enjoyed by narrow-based interests. As such, these policies represent the difficult choices in American policy making. Policies excluded were such items as the Bush tax cuts or 2002 farm reform where the primary thrust was to restore or provide new benefits to specific interests. The list was developed based on that of "major" policy changes defined by David R. Mayhew in his book, *Divided We Govern*.[80]

Policy Change	Crisis	Description
1982 TEFRA	No	Undo Part of 1981 Reagan Tax Cuts
1983 Social Security Reform	?	Save Social Security from trust fund depletion
1986 Tax Reform	No	Reagan initiated reform to broaden base of tax code
1988 Medicare catastrophic	No	Provide seniors with catastrophic and drug coverage
1990 OBRA	?	Over $500 billion in bipartisan deficit cuts stemming from bond market pressures
1990 Clean Air Act	No	Cuts in acid rain through cap and trade
1993 NAFTA	No	Bipartisan treaty negotiated by Pres Bush and pushed through by Clinton
1993 Deficit Red	No	Nearly $500 billion in deficit reduction achieved by Clinton and Cong Dems
1996 TANF	No	Welfare reform achieved through bipartisan change
1996 Farm reform	No	Ramping down of subsidies through bipartisan change
1996 Telecommunications reform	No	Congressional action to spur competition in industry
1997 Balanced Budget Act	No	Bipartisan deficit reduction includes tax cuts and Medicare cuts
2002 DHS	Yes	Stand up DHS in response to 9-11
2002 Sarbanes-Oxley	Yes	Financial market reforms in response to Enron crisis
2010 Health Reform	No	President Obama's signature reform
2010 Financial Reform	Yes	Reforms instigated by 2008 financial crisis

The three major deficit reduction initiatives passed during the 1990s were developed under differing political regimes. As Box 5 shows, two constituted cross-partisan or bipartisan agreements during a time when the president and Congress were controlled by opposing parties. By contrast, the 1993 deficit reduction legislation was achieved by President Clinton working with Democratic majorities in Congress without a single Republican vote in either the House or the Senate.

Box 5: Deficit Reduction Initiatives, 1990s

Congress and the president succeeded in passing three major deficit reduction initiatives in the 1990s, which together resolved deficits and brought about four years of budget surpluses.

- 1990 Cross-partisan agreement: Republican President George H.W. Bush was moved to work with congressional Democrats due to several factors. First, the reigning budget process required across-the-board cuts to be instituted to defense and nondefense programs in the absence of an agreement —cuts that were unpalatable to both parties. Second, the economic price of failing to reduce the deficit could have led to higher interest rates and possibly earlier recession, while an agreement could enable the Federal Reserve to ease interest rate pressures.

  A summit produced an agreement that ultimately called for fiscal sacrifice by both parties. Republicans had to accept higher taxes, with income tax rate hikes for upper-income individuals and excise tax increases for alcohol and tobacco. Significant cuts in Medicare and other entitlements were the price that Democrats had to pay. Caps on discretionary spending would slow future growth in both defense and domestic programs, although the 1990 agreement gave a generous one-time increase in those accounts. The 1990 package yielded a net of $496 billion in deficit reduction over five years. The politics is characterized as "cross-partisan" rather than "bipartisan" because a majority of congressional Republicans rejected the deal, which was initially defeated in Congress. However, a majority of Democrats and significant numbers of Republicans supported a revised package that became the Omnibus Reconciliation Act of 1990, signed by President Bush.

- 1993 Partisan agreement: The Deficit Reduction Act was passed through negotiations by President Clinton with his fellow Democrats controlling the House and Senate. Not a single Republican voted for the bill in either house, and Democratic moderates defected to oppose the agreement in both houses. The 1993 act was a continuation of the framework of the 1990 agreement, with caps on discretionary spending, cuts in Medicare and hikes on tax rates for high-income individuals. Total savings were $433 billion over five years. Of this total, $241 billion came from higher taxes, with higher rates for the wealthy and increased taxes on Medicare payrolls and Social Security benefits comprising the major share. $77 billion came from mandatory spending savings, with Medicare constituting the bulk of these savings and the remainder coming from extending discretionary caps and debt service savings.[81]

- 1997 Bipartisan Balanced Budget Act: Chastened by the reelection of President Clinton and their loss of public standing during the government shutdown, congressional Republicans displayed a new eagerness to negotiate a balanced budget agreement with President Clinton. The president was also eager to cement his legacy as a fiscal conservative, as well as to set a stronger political and fiscal foundation for establishing new priorities for government. On top of this propitious political environment, the high-growth economy lowered the bar to achieve a balanced budget by delivering far higher revenues than projected.

The agreement provided for $204 billion in deficit reduction over five years, far less than the other two agreements had done. Spending cuts fell along familiar lines, including extending discretionary spending caps and providing Medicare savings through controls on provider payments. Unlike previous agreements, this one included significant new tax and spending programs that ate into projected savings. Thanks to Republican pressure, the president accepted net tax cuts of nearly $95 billion, including capital gains tax cuts, higher education tax credits and a child tax credit. The president obtained nearly $30 billion for mandatory spending expansions, including the new State Children's Health Insurance Program or SCHIP.

What were the forces that promoted agreement?

- Political opportunities: Leaders were anxious to claim credit for making fiscal progress that could signify effective management of government and the economy. One example of this was President Clinton, whose embrace of deficit reduction was not a theme of his 1992 campaign, but served his political interests in signifying his arrival as a "new kind of Democrat," and in appealing to the large share of voters captured by Ross Perot. Similarly, Republicans controlling Congress, although initially confrontational with Clinton, came to see advantages in negotiating with the president in 1997 due to the leverage he achieved in exploiting the unpopularity of their plans to shut down the government and his reelection in 1996.

- Economic goals and risks: The American public holds the President uniquely accountable for the state of the economy during his term. Fiscal policy is perhaps the most important lever that presidents have over economic outcomes such as interest rates and employment. President George H.W. Bush was convinced that deficit reduction was essential in reducing pressures for higher interest rates, which could have choked off growth. The Federal Reserve Board Chair Alan Greenspan reinforced this by commenting that deficit reduction would enable the Federal Reserve to lower rates below what they would have otherwise been.

- Broader policy goals: Deficit reduction is generally undertaken not just for its own sake, but to achieve broader policy goals. A key question dividing the parties over time has been: How large should government be and how can a balanced budget agreement achieve these broader goals?[34] President Clinton undertook deficit reduction partly to achieve a measure of fiscal flexibility for new investments, which had been crowded out by high interest costs and low revenues. He viewed budget balance as a way to "save government from its own excesses so it can again be a progressive force."[35] By contrast, congressional Republicans in the mid-1990s used deficit reduction as a vehicle to reduce the size and role of government by putting pressure on domestic spending programs through a combination of balanced budgets and lower revenues.

Interestingly, divided government prevailed for much of the period when fiscal progress was made. While much is made of differences between the parties, they both seek to appeal to broader public moods and values. When deficit reduction becomes one of those broadly shared values, it is not surprising that both parties may share common goals. Moreover, they may see advantages to collaboration since achieving policy change can validate their standing as "doers" who achieve real changes on behalf of shared values and interests. Finally, divided government may facilitate hard choices by sharing the blame, a risk that a leader of a unified government may not be willing to take.

The 1990s showed that action in divided government is by no means predictable or linear. As Daniel Palazzolo remarks, it is not surprising that the 1997 bipartisan balanced budget agreement followed two years of partisan stalemate and posturing, including the shutdown of the government. In some respects, it was necessary for congressional Republicans to prove their ideological mettle to their core supporters before realizing the political limits of this strategy, which paved the way for bipartisan collaboration with President Clinton.[36]

Fiscal events following the 1997 budget agreement help illuminate the role that divided versus unified government can play in promoting or frustrating fiscal discipline. Having achieved a surplus starting in the late 1990s, divided government then became a source of stability, preventing either party from having sufficient votes to dispose of the surplus through spending increases and/or tax cuts. Conversely, when unified party government returned during most of the George W. Bush presidency, the surpluses vanished and deficits returned. Bush was successful in using his new-found control over Congress to pass large tax cuts, new defense spending for the wars in Afghanistan and Iraq and a large new entitlement program providing prescription drugs for the elderly, often with significant Democratic support. All in all, these actions not only used the entire projected surplus for the decade of $5.6 trillion, but led to deficits in each fiscal year for which Bush was responsible, ranging from 1.2 to 3.5 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 more time to qualitative and quantitative research to understand the other side of the political equation: How leaders can structure these choices so they can survive, and even thrive.

Why do democratic leaders decide to undertake fiscal consolidation in the absence of a true market crisis? As noted earlier, conventional wisdom suggests that leaders have short-sighted 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 have flexibility to respond to cues from the public, markets, broadly shared norms and political coalitions.

Reframing the Public Debate: Making Ideas Matter

In a democratic society, leaders are often portrayed as being bound to support the position of public opinion or the "median voter." While much of the public can be characterized as being inattentive on specific policy issues and uninformed, nonetheless elected officials must be wary of their potential mobilization in determining their positions on policy issues.[37]

However, the influence of various publics is far less direct than imagined in popular lore or some of the political economy literature. Because the public typically does not speak with a single, clear voice, there is considerable room for political officials to shape the views and the mobilization of various publics on specific issues.

Recent research suggests that leaders are less focused on catering to or pandering to median voters and more focused on pursuing the policy goals of their own coalitions. These leaders pursue crafted talk to link their own proposals to the prevailing moods of the broader publics.[38] This top-down framing and leadership of public opinion has become even more pronounced in an era of more polarized politics where elected officials increasingly are drawn from the extreme wings of both parties.

How do leaders reshape the focus of debates? By reframing what the debate is about. This means changing the definition of the issue by highlighting the salience of one facet or dimension over others. Shifting the focus of debates need not entail convincing the other side that they are wrong in an absolute sense. Rather, it calls for the less demanding task of shifting the relative priority of different values and priorities that most of us care about. [39]

For fiscal policy debates, this means that leaders need not convince the public that their attachment to low taxes or social security benefits are misplaced in some absolute sense. Rather, policy change occurs when leaders succeed in showing the consequences of these policy attachments for other values that broader publics are equally attached to, namely fiscal and economic sustainability.

Recent research on the policy process highlights the critical role that framing can play in altering long-standing policy arrangements. Leaders have windows of opportunity when they can reframe what the debate is about. Thus, for instance, tobacco policy was reframed over time from a debate over how to promote the industry and its product to one over the health effects of the product. Shifting the focus of the debate brought in new actors and portions of the public who were previously unengaged in the tobacco policy arena. Eventually, the change in the battle for ideas forced the tobacco lobby, once the most feared interest groups in Washington, to close its doors.

In this regard, leaders can take decisive action when the broader publics are profoundly ambivalent about fiscal policy and consolidation. Typically, publics do not like deficits but also have strong support for continuing current taxes and spending programs. Box 6 illustrates the public's ambivalence about fiscal policy in the United States in 2010.[40]

These conflicting views change in relative salience over time, providing openings for leaders who wish to reduce deficits to mount campaigns. While interest groups may hold sway in opposing cuts or tax increases, party leaders can reframe the debate by appealing to broader values served by deficit reduction. In the 1990s these appeals successfully mobilized broader publics that stood on the sidelines while deficits increased. The successful reframing of debates thus changes the distribution of influence and can produce rapid and major shifts in public policy. Some prominent political scientists suggest that policy making resembles a "punctuated equilibrium" where periods of policy stability are suddenly overturned and uprooted by shifts in issue framing and ideas, leading to broad policy reforms that the pundits failed to predict.[41]

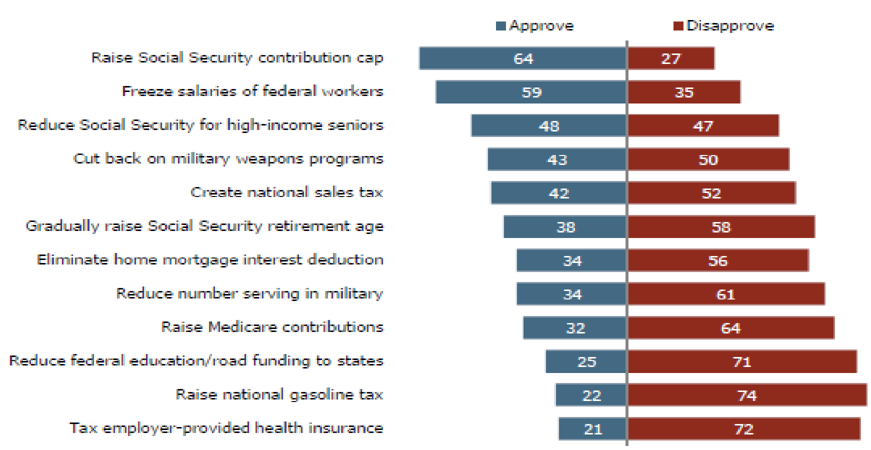
Box 6: Public Ambivalence on Deficits

The charts below illustrate the broad public agreement on the need to address deficit reduction, but also widespread conflict and opposition to many specific proposals for reducing the deficit. Data is based on a Pew survey reported on December 9, 2010.[82]

Public Views on Deficit

Deficit is major problem, must address now	70%
Deficit is major problem, address when economy is better	23%
Not much of a problem	1%
Don't know	5%

Public Views on Options to Reduce the Deficit



In 2011, the economic recession coupled with large federal deficits have appeared to open a window of opportunity for leaders to deal with the deficit. Without a crisis, budgetary concerns have risen to a prominent place on the national agenda, reinforced by the reports of the three budget deficit commissions. Of course, it remains to be seen whether the system will follow through and take action on a specific program of spending cuts and tax increases.

Exercising Foresight: a Politically Natural Act?

What prompts leaders to use their policy leeway to address deficits, given the notorious political risks that such a venture can bring about? While leaders are beseeched by organized interests to increase spending and reduce taxes, there are countervailing pressures that provide political incentives for public officials to address deficits as well.

Keech, among others, argues that political leaders have incentives 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 account for the history of budget balance and fiscal consolidations that have occurred in many democratic regimes.[42]

Gary Jacobson, a prominent political scientist, concluded that many members of Congress were able to take the longer view when voting for the 1990 deficit reduction agreement in the United States.[43] The following factors helped insulate members from the immediate short-term reaction of publics to deficit reduction packages:

- Presence of weak challengers
- Two thirds of U.S. Senate not up for reelection
- Lack of salience of issue-voting in elections
- Presence of large numbers of safe seats

Further, Jacobson makes the point that many members have incentives to focus on the longer-term outlook for the budget. Most members of Congress in fact are long-term careerists whose time horizons extend well past the next election cycle. They have an interest in providing for deficit reduction to free up fiscal space for their own future initiatives. A future of growing deficits virtually assures that their longer-term political careers will be preoccupied with difficult fiscal choices and limited flexibility.

Research that examines the politics of pension reform notes that the design of pension policies is informed by longer-term considerations. For instance, the linkage of Social Security or other spending programs to dedicated revenues is driven by a concern that such programs will be able to have a smoother flow of resources over the longer term, or that program spending should be constrained by the amount of revenues available for specific purposes. Research on the political impetus for reform of long term commitments notes that political leaders are not just driven by the next election but by long-term policy legacies. The resolve of leaders can at times be reinforced by interest groups who are disposed to view issues from a longer term perspective. When their own future claims are threatened by ballooning fiscal costs, these groups have an incentive to champion change to give them a seat at the table in renegotiating policy bargains. [44]

Leaders and Markets

As the foregoing suggests, the state of the economy is critical to the popularity of public officials in most democratic systems. In the United States, the president's approval rating and reelection prospects are in no small part determined by how well the domestic economy is performing. While members of Congress can obscure their own connections to economic outcomes, presidents do not have this luxury. It is not surprising, therefore, that successful national leaders have proved adept at framing deficit reduction as their economic growth program.

Fiscal consolidations indeed are typically undertaken to influence the behavior of financial markets whose collective performance goes a long way in determining interest rates and currency values for any free market economy. Politically, it is important to justify the sacrifices involved in fiscal consolidation 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. In gaining leverage over market perceptions and outcomes, market actors such as bond market traders and central bank officials gain significant reciprocal influence over national fiscal policy making.

The fiscal crisis model foresees markets influencing governments through the precipitation of a serious crisis. Indeed, there are nations such as Argentina where procrastination did lead to a market-driven external shock and crisis. Others instituted fiscal consolidation only when pressures from the credit markets precipitated uncontrollable currency free falls and interest rate spikes, such as occurred in New Zealand and Australia in the 1980s.

However, market influence over policy making in many systems is often far more incremental and routinized. Rather than an absolute precipitous crisis, most of the nations achieving fiscal consolidation and even surpluses did so partly in response to incremental market pressures manifesting themselves in changes in prices and costs associated with their debt and currencies.

Indeed, in some cases, markets organize political interest groups to pressure government officials. Some refer to these groups as "bond vigilantes" to reflect the proactive political strategies undertaken by major financial firms and other institutions with an interest in reducing the cost of government debt and interest rates. Adam Posen has developed a systematic framework for explaining the differential influence that financial banking interests have over national macroeconomic policy making, suggesting that central banks influence is a function of their institutional structure and autonomy, as well as their actual influence in policy making as an interest group. [45]

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. 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 growth and recovery effects that many attribute to fiscal retrenchment in certain nations. [46]

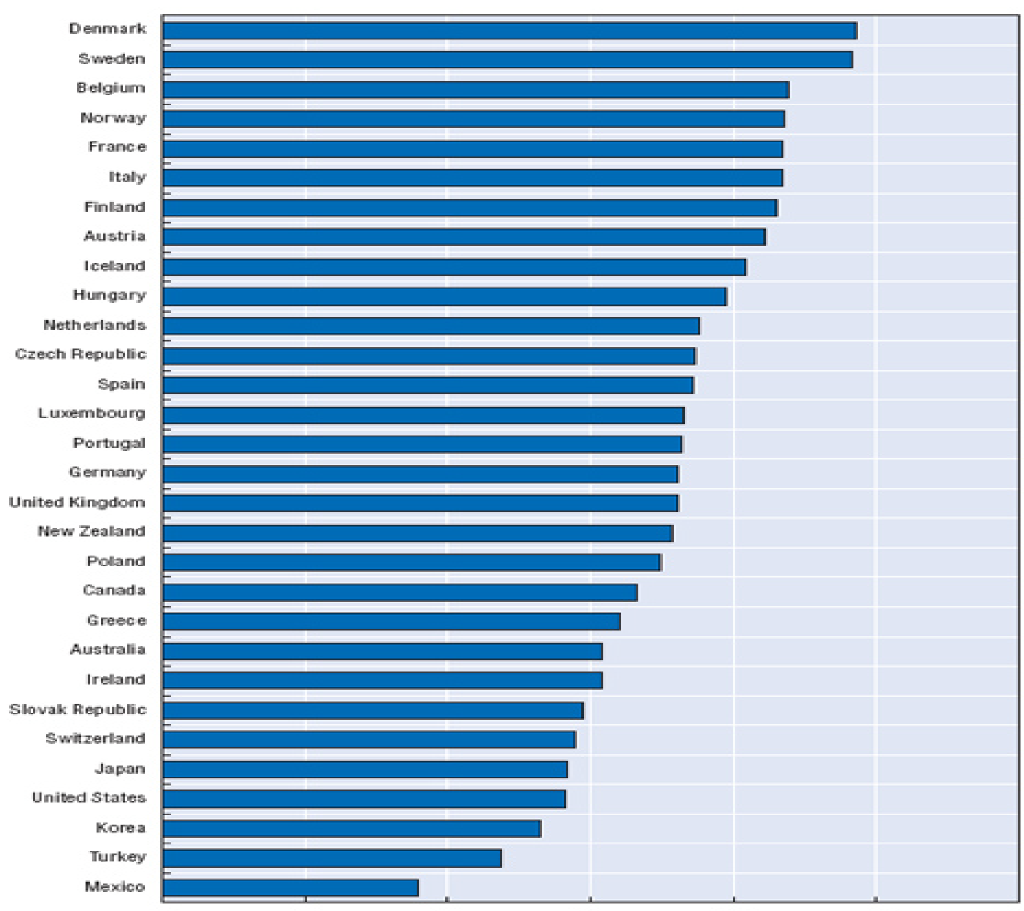
Norms of Fiscal Discipline

Granted there are powerful incentives promoting fiscal expansion, but they are not the only drivers of fiscal behavior. Norms and ideas have significant gravitational pull on policymakers and publics alike—pull that often enables them to see beyond near-term payoffs.

For most of American history, for instance, balancing the budget has been part of what we might call the norms of our policy-making process. Most leaders and the public acted as if budget balance was the primary norm governing fiscal policy. Even during the massive government expansion of the New Deal, President Roosevelt took action in both 1933 and later in the decade to curb spending, with the goal of returning to a balanced budget.[47]

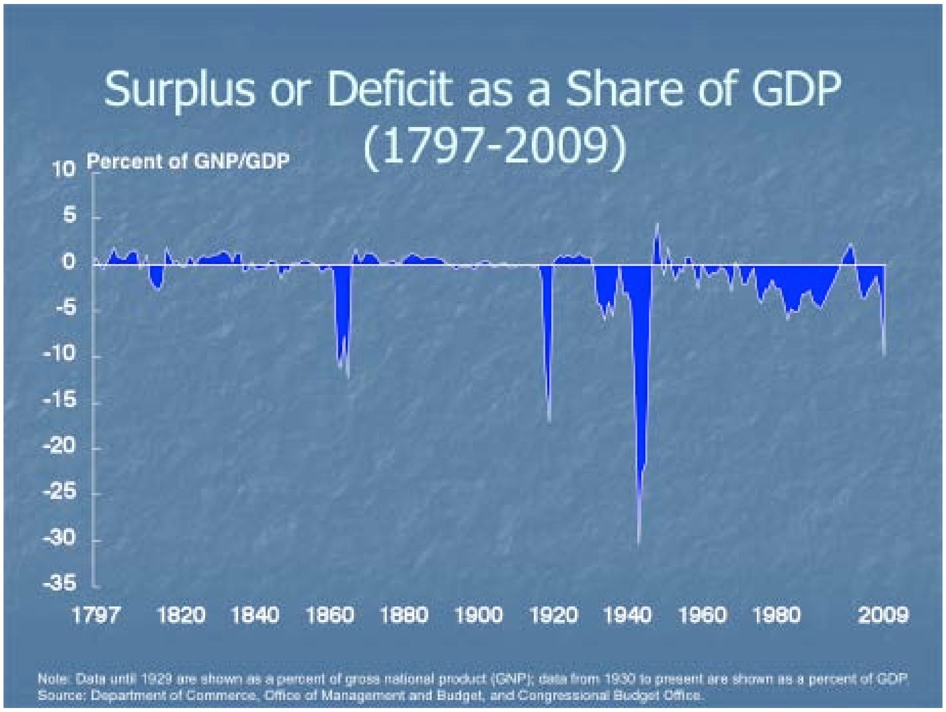
Our tradition of limited federal government is another norm that has proven to be long lasting. While the crisis model predicts that policy makers have every incentive to plunder the public fiscal commons through higher spending and taxes, the federal role in the economy remains among the lowest of any OECD nation, as shown in Figure 5 comparing taxes as a share of the economy. Charles Schultze showed that residual concerns about budget balance and the federal role limited federal spending to less than the levels that would be predicted from the nation's population, density, aging and other factors associated with spending pressures.[48]

Figure 5: United States Tax Burden Relative to OECD Nations



Until the 1970s a plotting of our fiscal history reveals a strong preference for balanced budgets and surpluses, except during wars and depressions, as shown in Figure 6. For most of our history, the idea of budget balance was not enforced by elaborate budget machinery or points of order. Rather, the consensus was so strong that the norm itself became a significant constraint on behavior.

Figure 6: Historical Record of U.S. Fiscal Policy



As shown in Figure 6, the "civil religion" of budget balance was defrocked after 1970, as the nation experienced nearly three decades of deficits in the absence of great wars or recessions. The embrace of Keynesian economics by parties, the growth of entitlements, the greater public pressure on presidents and members of Congress to deliver publicly funded programs and tax cuts all contributed to the erosion of this norm.

However, it can be argued that the old norms of budget balance are still alive in the American system. Only time will tell if that is true, of course, but certainly such norms have valence across the broad inattentive publics, a fact exploited in the 2010 elections.

This pattern is consistent with what we might call the thermostatic model of fiscal policy making articulated by Allen Schick. Given our strong attachment to budget balance norms, Schick posits that we will collectively come to grips with deficits when they rise to alarming proportions. Recent history supports this, as Congress and the president both eliminated deficits and moved to surpluses through the 1990s. But as Schick notes, the self-correction works in both directions. As surpluses emerged, we reversed fiscal course, expanding spending and cutting taxes during this past decade.[49]

Political Coalitions

Given the heavy political lift involved in passing fiscal consolidations, conventional wisdom would suggest that 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. [50] Since proportional representation systems tend to foster politically fragmented regimes, some have generalized that governments with majoritarian electoral systems maintain tighter fiscal discipline than others.[51] Tsebelis shows that governments with fewer veto players are able to promote broader-scale change.[52]

In view of these findings, many would conclude that our separation of powers system is a unique obstacle that is borne by leaders in the United States. Thanks to split ticket voting, divided government has emerged as the norm. Since 1946, at least one house of Congress and the presidency has been in control of different political parties for 21 of the past 30 years. As parties have become more polarized, the differences across parties have proven to create even greater obstacles to agreement on politically difficult choices.

By contrast, parliamentary systems and other strong party regimes appear to be free of the potential for gridlock that seems to paralyze our own system at times. Once the governing party decides on its course, it is undeterred by the checks and balances that complicate legislative approval in our separation of powers system. However, even though technically feasible, no government is anxious to reach for reforms that might lead to its demise.[53] In fact, typically, fiscal consolidations still entail difficult choices and bargaining within parliamentary systems, but the conflicts are resolved within the government before legislation is introduced.

Nonetheless, our own experience and that of other OECD nations has shown that it is not only possible but often necessary to achieve cross-partisan involvement in fiscal consolidation. Case studies on fiscal and pension reforms suggest that governments that engage multiple parties and factions in collaborative fiscal sacrifice are more likely to not only enact consolidations but to sustain these reforms over time. Fiscal consolidation is a group exercise, best done with the support of a broad coalition. One OECD study concluded that multiyear plans requiring fiscal sacrifice must necessarily engage numerous stakeholders and political factions.[54]

Paul Pierson notes that many advanced nations succeed in public pension reforms, not through, "normal party politics," but through more consensual mechanisms building support across party lines. While parties were eager to claim credit during the period of welfare state expansion, they are equally eager to share the blame during retrenchment.[55] Box 7 illustrates how Social Security and welfare state reforms over the past 20 years were based on multi-party deliberation and consensus in many advanced nations.

Box 7: Multi-party Vehicles in Pension Reform

OECD nations have shown a propensity to rely on broader-scale consensual approaches to pension reform:

- 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.
- Switzerland and New Zealand – held referenda on major pension reforms in 1995 and 1997.
- Austria – 1997 reform a product of government bargaining with the unions
- United States – 1983 commission with participation by leaders of both parties developed a consensual Social Security reform including extending retirement age and raising taxes.

Two particular forms of cross-partisan coalitions are worth singling out here:

- Counterintuitive fiscal consolidation and reform: In nations like Australia and New Zealand, left wing party leaders became credible reformers reaching beyond their core base of supporters to champion reforms in the name of greater economic growth. This "Nixon going to China" strategy enabled these leaders to enjoy more credibility as protectors of underlying programs than other party leaders might have. Also, when left parties move to the center, they leave their supporters trapped with no other credible choice, short of the formation of third parties.
- Joint sacrifice: One of the forces that prevents agreement on fiscal consolidation is the anticipation by each party that their sacrifices will be exploited by the other side, much like the prisoners' dilemma discussed earlier. In nations like the United States, Social Security was reformed in 1983 when both parties agreed to an approach that indemnified each other from sniping and criticism. Armed with joint agreement, they avoided exploiting the other side's willingness to compromise. Democrats agreed to Social Security benefit cuts and Republicans agreed to higher payroll taxes and neither criticized the other for making these concessions. In essence, the leaders of both parties jumped off the cliff holding hands, confident that their actions would gain both mutual approbation rather than condemnation. This became a win-win-win outcome, as both parties at least did not lose and the national budget and economy gained from substantial reforms stabilizing the finances of the Social Security program for nearly 30 years.

The Fiscal Efficacy of Divided Government

In the United States, political scientist David Mayhew has shown that most of the major reforms in public policy enacted by the federal government during the postwar period were achieved through our own version of cross-partisan coalitions; divided government.[56] Often policy reforms occurred only after years of partisan gridlock and contentious debate. Party leaders in a divided government setting are torn between appealing to their core supporters by demonstrating their fealty to key party priorities and their desire to achieve substantive results that make a difference to the median voter in the center of the political spectrum.

Mayhew shows that there are powerful incentives inducing either outright bipartisan cooperation or copartisan bargains between selected factions of both parties. Of the 267 important laws passed from 1946 through 1990, 70 percent passed by a two-thirds majority of both houses, winning the backing of a majority of Democrats and Republicans. Not only are broad majorities required, even when a single party controls the presidency and Congress, but public moods often sweep over both parties, requiring both to respond in similar ways to a compelling issue definition placed on the agenda.

For fiscal policy, the evidence appears to be mixed. Divided government can certainly exacerbate partisan gridlock over deficit reduction, as noted in the prior discussion of fiscal retrenchment in the United States. Some research suggests that deficits could be larger under divided government regimes where both parties collude to expand fiscal policy to reward their mutual constituencies—lower taxes for Republicans, higher spending for Democrats.[57]

However, there is also evidence suggesting that divided government can facilitate cross partisan agreements on retrenchment by sharing blame and risks of political fallout from agreements. Jonathan Rauch argues that, when acting as a minority, today's ideologically pure parties have every reason to obstruct the majority, playing to their base and hoping to undermine their ability to establish success as a governing party.[58] By contrast, divided government can provide incentives for the congressional majority party to join up with presidents, if for no other reason than to avoid blame as obstructionists. The Republicans in control of Congress in the 1990s actually began as partisan ideologues interested in embarrassing the president through government shutdowns and legislation playing to its conservative core. When that failed and the president won both the election and public approbation, they moved to the center to join in the 1997 bipartisan budget agreement. They had a stake in succeeding in balancing the budget, as did President Clinton.

STRATEGIES FOR DEFICIT REDUCTION

Leaders must also cover their political risks by pursuing strategies that enable them to craft deficit reduction packages that mobilize public support and mitigate political losses. Imposing loss is never easy in democratic systems and leaders need to think consciously about how to both justify and indemnify themselves from the political fallout.[59]

Framing the exercise in compelling terms is critical to justify the sacrifice. Research on welfare state reform in OECD nations confirms that a key to the successful public support for reform is the ability to reframe the budget debate to highlight the broader benefits for the aggregate economy and budget.

Leaders that refocus attention to the broader collective effects of reform on national economies can win the battle to determine what the debate is all about. Fiscal rules that highlight the collective effects of individual decisions further help leaders elevate attention to the bigger picture.[60]

Beyond this, research has noted classic strategies pursued to facilitate the imposition of losses in advanced democratic nations:[61] Major strategies include:

- Sharing sacrifice through such strategies as across the board cuts and balancing spending and revenue actions. Such strategies help promote a perception of fairness. They also intercept prisoners' dilemmas by ensuring groups that their sacrifices will not be exploited by political competitors who might dodge the deficit bullet.

- Compensating losers with packages that cement coalitions by providing gains to offset a portion of the losses of major groups. One example is the tax reform proposals proposed by the President's deficit reduction commission in December, 2010. The reductions in tax expenditures from eliminating such breaks as mortgage interest deductions would be partially offset by dramatic cuts in tax rates.

- Phasing in cuts by making wedge shaped cuts that grow over time. The political impacts of spending cuts and tax increases can be substantially blunted if they are phased in over a number of years to provide ample time for transition and adaptation. For instance, the social security reforms of 1983 phased in increases in the age for full benefits over several decades to provide time for those affected to adjust their career and savings pathways. It goes without saying that this strategy is not available in a market induced crisis, where immediate cuts in spending and tax hikes must be achieved.

- Promoting larger, more sweeping changes that can yield more demonstrable fiscal progress. Ironically, sweeping changes have been found to be positively related to political success. Large packages not only improve chances for dramatic gains in economic outcomes, but also helps promote perceptions of fairness by spreading the pain across more stakeholders. 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.[62] OECD research suggests that large multi-year adjustments can make reforms possible that would not have been able to find support on their own.[63]

Douglas Arnold suggests that many of these strategies help democratic leaders protect themselves against the political risks associated with fiscal consolidation.[64] 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 and avoid blame.

Other strategies have proved critical to sustaining political support for fiscal consolidation. For example, 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.

Fiscal Rules

What role do fiscal rules and budget process reform play in prompting national leaders to address fiscal challenges in a more timely way? At their best, fiscal rules can supplement and reinforce the strategies and frames that leaders set forth to justify fiscal sacrifice. However, they cannot replace or supplant democratic politics, nor can they alone justify or legitimize the hard choices necessary to resolve deep-seated fiscal deficits.

A recent IMF study shows that fiscal rules have become more widespread throughout the world. 80 nations have them, compared to only seven in 1990. Most have a combination of rules.[65]

Fiscal rules can 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.[66]

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 is perceived to be the fiscal ambivalence of democratic leaders.

Much as proponents of such rules desire them to be self-executing, 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." 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.[67] As Roy Meyers has said, budget rules are endogenous to the political system that created them, which constitutes both strength and weakness.[68]

Thus, budget process reforms and fiscal rules in democratic systems have an independent effect 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 are ignored in strong single-party regimes that can rely on a hegemonic direction by the government leaders.[69]

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 were increasingly disregarded as surpluses emerged in the late 1990s. They became even more irrelevant when President Bush was able to work exclusively with a Republican controlled Congress to achieve his fiscal policy objectives without Democratic Party assistance.[70]

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.[71]

POLITICAL REWARDS AND RISKS

When nations 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 one percentage point in the deficit/GDP ratio 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 perceive that deficits will entail tax increases or spending cuts in subsequent years.[72]

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 be 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. [73]

Several qualitative analyses of the politics of fiscal austerity in selected advanced nations come to similar conclusions. The GAO study of deficit reduction in select OECD nations in the late 1980s revealed that these nations often instituted 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.

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 those better able to absorb them, 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 1990s, the episode of fiscal retrenchment enabled the GAO to conclude that significant structural policy changes and sacrifice is indeed compatible with democratic politics.[74]

A study 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 conventional wisdom 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. Ultimately, nearly every nation fell into deficit during the Great Recession, but the nations with sustained surpluses experienced less wrenching fiscal choices.

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.[75]

CONCLUDING OBSERVATIONS

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 prompt the need for fiscal consolidation. As the role of government in the social and economic lives of nations has grown, so have 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 policy making. The best way to effectively deal 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. Summoning publics to support fiscal sacrifice is a task that carries liabilities for leaders in any democracy. And there are certainly many cases where democratic nations have failed to rise to this challenge, including our own.

However, this does not mean that democratic politics and fiscal opportunities inherently clash. As contrasted with conventional wisdom and certain academic literatures, democratic nations are not doomed to be reactive to market pressures alone. Rather, the record shows that policy makers 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. Elected leaders at times are rewarded by publics that are persuaded to view sacrifices as necessary for the broader public good. While leaders may indeed attempt to justify their actions based on what they define as a "crisis", often these actions are taken to head off a serious exogenous crisis, as we have defined it in this paper.

Given the high stakes involved with the democratic response to deficits, more research is needed to explore how democratic nations achieve fiscal reform and change. We also need to better understand how such fiscal consolidation initiatives are thwarted and delayed. The conventional wisdom may be exactly right in predicting a bumpy road for those who champion fiscal consolidation in the United States and elsewhere. Indeed, nations in Europe such as Greece and Portugal illustrate that procrastination in facing up to fiscal challenges characterizes the initial response of many democracies facing incipient deficits.

Those who would predict frustration and gridlock over fiscal consolidation may be correct most of the time. But they are wrong at crucial times—and these are the times when democratic systems can quickly break through barriers to achieve significant fiscal progress and reform. Understanding when those turning points occur and how to promote politically sustainable shifts in fiscal policy are the central tasks facing our system.

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 proactively deal with the major fiscal challenges of our time.

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