Austerity Politics

Is the Electorate Responsible?

PÅR NYMAN
This thesis contributes to the public finance literature concerned with fiscal sustainability, and consists of an introduction and four stand-alone essays. The first three essays analyse the reasons why governments accumulate large levels of debt. In the first essay, I find that parties that implement fiscal consolidations are punished by the voters in the following election. However, there does not appear to be a rewarding effect for governments that implement fiscal expansions. The second essay, which is co-authored with Rafael Ahlskog, shows how voter opposition to fiscal consolidation is shaped by moral considerations and feelings of personal responsibility. More precisely, we argue that voters are more likely to refuse fiscal consolidation when they do not feel responsible for the public debt. The third essay argues that misperceptions about the business cycle would have caused fiscal problems even if policy-making was conducted by independent experts. According to my estimates, biased projections have weakened annual budget balances by approximately one per cent of GDP. In the fourth essay, I argue that budgetary mechanisms created to improve fiscal discipline have a bias toward a reduced public sector. Because discretionary decisions are usually required to adjust public expenditures to price and wage increases, periods of rapid growth have repeatedly caused the welfare state to shrink. I use the introduction to discuss the commonalities between the essays and to situate the field of public finance in a broader, historical context.

Keywords: Deficit bias, Fiscal policy, Perceptions, Political economy, Responsibility, Retrospective voting

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List of papers

This thesis is based on the following essays.


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When I began this journey, I had no ideas for the subject of my thesis. I had just left my job at the Swedish Fiscal Policy Council and I promised myself that I would write my dissertation about something far more interesting than fiscal policy. With the final product in my hands, it is obvious that I have failed. Apart from broken promises, my time as a PhD Candidate has been an exciting and joyful experience. For this, I am grateful to a large number of people. Regrettably, there are so many people I would like to thank, I cannot acknowledge them all by name.

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When writing the last words of a dissertation, I suppose that most people consider the reasons why they applied to a PhD programme. In one respect, I grew up without an idea about what a career in academia means. During my undergraduate studies, I did not know what a PhD student was and I sure had no intention of becoming one. On the other hand, it is clear that I have spent most of my upbringing in an environment in which it would eventually become a natural choice to pursue a PhD. Among the friends I made in secondary school and during my time in a political youth organisation, there are at least twenty who have pursued a PhD. Notwithstanding selection effects, to me that shows how important that environment must have been for my own choice to eventually pursue a career in academia. Thank you all.

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Introduction

The tension between the market logic and democracy is fundamental to the history of democratic capitalism. As markets have expanded into new aspects of social life – and especially when the market outcomes have fundamentally contradicted other principles – they have consistently been met with popular resistance. To protect society from what has been perceived as the destructive potential of free markets, solidarity organizations and legislation have been used to subordinate markets to societal control. The best example is probably how unfair prices (Kahneman et al. 1986), typically represented by price hikes following a sudden shortage or wage cuts in a recession, have been met with minimum wages and other forms of price control. This dialectical process between market expansion and society’s counter-movement is what Polanyi has called a double movement (Polanyi 1944).¹

Many economists have been puzzled by this resistance to market mechanisms. Rodrik (1996) raises the question of why people protest against the structural adjustment programmes, and Bryan Caplan’s conclusion that people have an anti-market bias in their beliefs and attitudes (Caplan 2001, 2004) echoes the frustration found among many 19th century economists (Bastiat 1965; Newcomb 1893). When it comes to pro-market reforms, many social scientists have noted this popular resistance but reached the conclusion that the goal can justify the means (Stokes 1996). Harberger (1993) is therefore full of admiration for a handful of ‘heroes’ who have implemented market-friendly reforms despite public resistance.

Because the struggle against the market logic can lead to inefficiencies – and ultimately threaten the profits and property of capital owners – there has always been a pro-market reaction against this counter-movement. To secure the market forces and the property of capital owners, government repression against labour unions, as well as institutional constraints on populist governments, have restricted the power that this counter-

¹It would not make sense to take a normative stance in the general conflict between the market logic and the principles that cause this counter-movement. These principles constitute a mix of religious beliefs, psychological biases, vested interests, traditions, preferences for equality, human rights, norms about social justice, etc. Besides, the relative merits of the market logic, and the resistance against it, differ between contexts. Few, if anyone, would like within-family relations to follow the same logic as transactions on eBay. For the same reasons, it is not my intention to apply any sort of guilt by association when actors of different times are placed on the same side in this conflict.
movement exercises over the economy. In its most extreme forms, this reaction has required the elimination of democracy. For example, most of Harberger’s heroes sided with the military and implemented their reforms following a coup d'état.

Today, the tension between economic prescriptions and popular will is most obvious in the treatment of public debt and deficits. Sovereign default is an old and recurring phenomenon, but public debt sustainability is far more challenging today than ever before, with debt in most countries being on unsustainable trajectories (Bertelsmann 2013). Dramatic austerity measures will be required to achieve fiscal sustainability, but it is widely assumed that such measures will be met by popular resistance. To improve fiscal discipline, governments are therefore advised to protect fiscal policy from too much popular influence by hiding cutbacks behind de-indexation, committing to expenditure ceilings several years in advance, and creating fiscal institutions with economic experts that evaluate the government’s policies. The most far-reaching proposals involve the delegation of actual policy to such independent bodies, similar to the way in which monetary policy has been delegated to independent central banks.

In order to find an effective balance between popular influence and fiscal discipline, it is important that we understand citizens’ opposition to fiscal consolidation, as well as what other factors have contributed to the fiscal problems. The first three essays in this thesis therefore analyse the reasons why governments accumulate large levels of debt. One essay argues that misperceptions of the business cycle would have caused fiscal problems even if policy-making was conducted by independent experts. The other two provide new knowledge about when and why voters choose to punish governments that implement fiscal adjustments. Over the last decades, many countries have reformed their budget process and other institutions, in order to improve fiscal discipline. In the fourth essay I argue that those institutions have a bias toward a reduced public sector.

I will use this introduction to situate the field of public finance in the broader context outlined in the introductory paragraphs. Because most readers will not be familiar with the public finance literature, this approach should provide a more stimulating reading experience than if the introduction was to have been limited to public debt and deficits. Besides, taking a wider view in terms of time, contexts and disciplines is a good way of broadening one’s horizon and identifying perspectives that are missing from the more narrowly focused literature.

The next section provides several examples of how perceived threats from the market have been met with a Polanyian counter-movement, and how the power of this movement has subsequently been restricted to secure the functioning of the market. I begin the section with the
most common forms of resistance in non-democracies before I discuss how this dialectic process has developed with the emergence of organized labour and universal suffrage. The historical examples eventually lead up to the contemporary problem of fiscal sustainability. The historical review is followed by a theoretical discussion of how we can understand this popular resistance. I then turn to democratic theory and the costs of putting constraints on the political process. This introduction ends with a brief summary of the contributions made in the four essays, together with a concluding discussion.

A story about the counter-movement

Resistance against the market logic has existed for thousands of years. In ancient Mesopotamia, where most transactions were based on credit, it was common that peasants borrowed from merchants for their own consumption. If the peasants could not pay, their possessions were soon appropriated. This began with grain and livestock, but if that was not enough to cover the debts, the debtors were forced to sell their servants, their family and – ultimately – themselves as slaves or debt-peons (Graeber 2011). These consequences must have been perceived as wildly unfair by the peasant population. To maintain social tranquility, both Sumerian and Babylonian kings began to periodically write off all consumer debt and return debt-peons, slaves and land to their original owner. In less than two centuries, Babylonian kings decided to carry out no less than fifteen such debt cancellations (Hudson 1993). The motivation given by Hammurabi himself for the 1761 BC restoration was that ‘the strong might not oppress the weak’. Naturally, this tradition was bad for the business of creditors as well as the functioning of the credit market. To protect their trade agreements from such intervention, creditors developed legal devices that made their transfers immune from debt remission edicts (Dassow 2011, p. 208).²

Anyone who has taken a basic course in economics has probably learned of the disastrous effects of rent controls in the housing market. The Swedish economist Assar Lindbeck went so far as to conclude that ‘next to bombing, rent control seems in many cases to be the most efficient technique so far known for destroying cities’ (Lindbeck 1971, p. 39). Yet,

²The Sumerian word *amargi* is the first known written reference to freedom or liberty (Kramer 1970, p. 79) and its cuneiform glyph has become a common symbol for libertarian organizations around the world. Amargi literally means ‘return to the mother’ and was used to denote these ancient debt reliefs, where persons and property were returned to their original owners. Thus, many hardcore libertarians today bear tattoos of the symbol of one of the world’s first state interventions.
different forms of rent control have been implemented in most rich countries, typically following a shock in either demand or supply (Willis 1950). In 1755, Lisbon was hit by one of the deadliest earthquakes in history. Most buildings in the city were destroyed and landowners responded to this shift in supply by increasing rents. This is an extreme example of when the market logic differs from the moral – most people must certainly have perceived this behaviour as the landlords taking advantage of human misery. Consequently, King Joseph prevented this ‘grave damage of third persons in the present calamity’ by freezing all rents (Willis 1950, p. 67).

The emergence of the modern market economy is best symbolized by 18th and 19th century Britain. After the Glorious Revolution in 1688, Britain was ruled by a parliament which was dominated by the wealthy. They successfully expanded markets by enclosures, colonial expansion and the repression of organized labour, all paid for by dramatically increased taxes and government debt (Greif 2008; North and Weingast 1989). As workers attempted to raise wages and implement price controls on food and clothing, they were always met with resistance. Factory owners made sure that the innovation of new machinery was aimed at reducing the bargaining power of skilled workers (Bruland 2004). Neither was collective bargaining an alternative, because combining to raise wages had long been illegal according to common law and in 1799 it was also made a statutory crime (Harris 2004). The industrial revolution drastically reduced demand for skilled craftsmen. When they could not participate in peaceful negotiations, many workers engaged in machine-wrecking and other forms of ‘collective bargaining by riot’ (Hobsbawm 1952). This was not taken lightly by the rulers and no less than 12 000 troops were deployed to break up the rioters.

The Polanyian counter-movement has been stronger among, but has not been limited to, peasants and the working class. Eventually the British parliament would also take actions to protect society from the worst consequences of the growing market economy. A mining accident at Huskar Colliery in Silkstone, near Barnsley, took the life of 26 children. The youngest victim was a girl of only 8 years old. Following this tragedy, Queen Victoria ordered a royal commission of inquiry which was led by Lord Anthony Ashley. In 1842, four years after the accident, the parliament passed the Mines and Collieries Act, which prohibited women and boys under ten years old from working underground. To the frustration

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This legislation was also motivated by gender norms and Victorian prudery. One of the pro-regulation arguments made by the commissioner Lord Ashley was that ‘girls and women [were] wearing trousers and working bare breasted in the presence of boys and men’. Female miners would later campaign for the right to work underground and in the year 1900 these parts of the acts were repelled.
of the more ideological liberals, more laws would soon follow and the amount of social legislation enacted by the parliament grew quickly. In 1884, the liberal political theorist Herbert Spencer – one of the most famous philosophers at this time – published his book *The man versus the state*. Spencer was obviously frustrated with the current state of affairs and in this 200 pages outcry, which referred to bans against child labour as well as most other legislation, he concluded that ‘interferences with the law of supply and demand, which a generation ago were admitted to be habitually mischievous, are now being daily made by Acts of Parliament in new fields’ (Spencer 1884, p. 85).

There are hundreds of similar examples. The Mesopotamian civilizations might have been the first, but debt cancellation came to be the standard demand in peasant revolts for millennia to come (Graeber 2011). Periodic debt cancellations were common in many cultures and the old testament gives support to such *Jubilees* every fiftieth year.4 The earthquake in Lisbon has few parallels in terms of real estate destruction, but the societal response has often been similar in the aftermath of a sudden shock to either market rents or wages. For example, rent control has been implemented following the 16th and 17th century plague in Paris, the 1917 fire in Salonika, the Chinese immigration to Hong Kong in the 1920s and – most importantly – during the two world wars, when most modern systems of rent control were created (Willis 1950). Machine breaking was mainly a British phenomenon, but similar demands have been raised by organized labour in every modern society. And social legislation would soon follow in other countries as they caught up to Britain’s fast industrialization.

*The early days of democracy*

None of the societies described thus far have been democracies. Most organized resistance by peasants and labourers were met with contempt from intellectuals and others who participated in the public debate.5 In the United States, where male suffrage was already a fact, leading intellectuals regularly expressed how unreasonable it was to give poor people the same power as well-respected entrepreneurs.6 The unreliable populace was also used as an argument for why the government should not be too involved in the economy. As we will soon observe, the debate about the government’s

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4This is also a good example of how the market logic contradicted the religious. If land belongs to God, and all men are his servants, how then can it be the permanent property of any man? See for example the Book of Leviticus (Leviticus 25:23).

5See Mcneil (2001) for a review of how one of the largest riots was depicted in British newspapers.

6This attitude was perhaps best captured by the contemporary historian Francis Parkman in his article *The failure of universal suffrage* (Parkman 1878).
role in the economy – and how we can design institutions that protect the economy from populist influence – would grow when democracy eventually prevailed.

How much democracy the economy can handle was a frequent topic for discussion in the early days of democracy. One of the first debates on democracy and fiscal performance took place in the United States between the progressives and the more conservative administration of William Howard Taft, when the framework for the modern federal budget was created (Rubin 1994). The progressives favoured an activist and expanding government, while the Taft conservatives wanted to shrink the government and were opposed to most government interventions. The progressives thought highly of the public and wanted to educate it to demand good government. The conservatives, on the other hand, lacked confidence in both the public and its representatives. In his book *Popular Government*, Taft argues that ‘the man from whom the people really secure the best service is the man who acts on his own judgment as to what is best for his country and for the people, even though this be contrary to the temporary popular notion or passion’ (Taft 1913, p. 60–61). This argument bears a strong resemblance to more contemporary views of why economic policy must be protected from the short-sightedness of voters and opportunistic politicians.

Polanyi’s double movement should not be understood as two balancing forces. On the contrary, during the interwar period, the tension between the masses’ attempts to take control over the market and the repression from those who feared this rising power became insuperable. The growing strength of labour unions and radical parties, the threat from the Russian revolution and the introduction of universal suffrage in many countries led to unprecedented power in the hands of the masses. But in too many places, this success soon came to an end as fascism came to power. It was not until after the the second world war, when there was eventually consensual support for democracy in most Western countries, that the golden decades of democratic capitalism could begin.

**The post-war counter-movement**

Throughout the postwar period, the most important demand from workers came to be the resistance against wage cuts and the protection from unemployment. The Great Depression had demonstrated that self-adjusting mechanisms are unreliable on the labour market, where workers do not accept wage cuts to clear the markets, and there was now a case for economists who argued that the government should take an active role in stabilizing demand over the business-cycle. Best known is of course John Maynard Keynes, but at the same time – if not earlier – similar ideas were
developed by Gunnar Myrdal in Sweden and Michał Kalecki in Poland. Most capital owners had opposed programmes for full employment during the 1930s, except for in Germany where there was no risk of the workers becoming too powerful (Kalecki 1943), but a post-war consensus was eventually reached. The threat of unemployment was reduced by an active stabilization policy and successively expanded unemployment insurance, while the economy benefited from class peace between capital and labour.

Democratic capitalism worked exceptionally well for almost three decades. Most rich countries experienced rapid GDP growth, a steady expansion of the welfare state and high levels of voter turnout, as well as other forms of political participation. The fast economic growth and the reduced degree of conflict in both policy-making and on the labour market probably contributed to the fact that mainstream economics in particular, but also other social science, adopted a relatively naive idea about how policy-making works. During the golden era of democratic capitalism, public finance was dominated by the social planner model. Not too far removed from Plato’s philosopher king, policy makers were replaced by an anonymous agent concerned with nothing but maximizing the interest of others. Researchers were occupied with defining an optimal policy and governments were assumed to follow it. There were of course exceptions. Marxists emphasized the state’s class character and argued that it had always worked as an instrument for the ruling classes (Jessop 1982), but marxists were at this time mainly found within the humanities and their influence was small. And from the emerging public choice school came a growing body of research which had developed alongside the dominant approach, with a much more cynical idea of how policy-making works, but their influence on the main writings in public finance was yet limited (Winer and Hettich 2008, p. 443).

During the first three postwar decades, it was widely believed that a trade-off existed between inflation and unemployment, in which governments could choose which position on this ‘Phillips curve’ they preferred. In the trade-off between unemployment and inflation, economists and conservative politicians have always favoured lower inflation compared to the electorate in general (Samuelson 1977; Senate 1952). Political scientists analysed the trade-off between inflation and unemployment as a conflict between socioeconomic groups (Boix 2000; Hibbs 1977) and as late as the late 1960s, this policy choice could still be described as a class conflict even in the most prestigious economic journals (Johnson 1968, p. 986). Confident in their own expertise, and sceptical about the government’s, many economists argued throughout the postwar period that central banks should exercise a fair degree of independence from the democratic pro-

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7Foster and Catchings’ 1927 book Business Without a Buyer elaborated on similar ideas.
cess (Senate 1952; Southard 1969), or, alternatively, that monetary policy should follow a pre-determined rule (Friedman 1962), otherwise inflation would be too high. However, because the goals of monetary policy were still contested, policy-making remained under democratic control.8

All of this would change with the stagflation of the 1970s. Real wages could no longer keep up with the productivity growth and the wage share began to drop. The magnitude and timing differed between countries, but everywhere it was accompanied by the unusual combination of both high inflation and increased unemployment. The failures were blamed on different forms of opportunistic behaviour and Samuel Huntington concluded that it was an ‘excess of democracy’ which had caused the difficulties in governing the economy (Crozier et al. 1975). Parallel to the economic problems, economists developed a theoretical explanation of the stagflation. The message was that in the long run, unemployment could not be held below its natural rate, and that popular attempts to reduce unemployment with expansive policies would only cause inflation to accelerate.9 This theoretical development, together with the stagflation of the 1970s and the relative success of early adopters like Germany, Switzerland and the United States, has influenced most rich countries to create independent central banks (Lohmann 2006).10 At least until 2008, independent central banks were claimed to have solved both the problem of inflation and major output fluctuations (Alesina and Stella 2010).

Just as inflation was put under control a new problem emerged. Government debt kept rising in many countries, even after the macroeconomic situation improved, and the deficits were larger than what could be justified by tax smoothing arguments (Barro 1979). The German sociologist Wolfgang Streeck analyses this sequence of happenings (wage resistance, inflation, public debt) as a result of a Polanyian counter-movement, where

8 Even in countries with de jure independent central banks, policy was de facto influenced by governments.
9 More precisely, if unemployment is kept under its natural rate, inflation will accelerate because wage-setting is based on expected inflation (Friedman 1968; Phelps 1967, 1968) and these expectations are affected by both observed inflation and expected policy. Kydland and Prescott (1977) added that governments have a problem with time consistency and credibility. After the government has announced its future policies and wages have been negotiated, the government has an incentive to change their policies in an expansionary direction. Because that temptation is anticipated by rational agents, the expansion turns into inflation. Barro and Gordon (1983a, b) argued that the problem would be smaller if monetary policy was rule-based and Rogoff (1985) showed that governments could overcome this time consistency problem by delegating policy to an independent authority.
10 Central bank independence means that governments are prohibited from giving instructions to central bankers and typically includes a target for monetary policy, the irremovability of central bankers and sometimes even rules against re-election.
workers demand non-market allocation principles when the economy is stagnating (Streeck 2011, 2013). He describes a difficult dilemma, where governments must choose between protecting the economy and being responsive to voters (Streeck 2014). Economists share a similar idea of a deficit bias inherent in the democratic process. For different reasons (see next section), there are electoral incentives for governments to run larger deficits than optimal. A wide range of institutions have been proposed and implemented to reduce this deficit bias. Medium term expenditure ceilings force governments to commit to a maximum spending level a few years in advance; targets for the budget balance make it evident for voters when a government is spending more than it should, and de-indexation of public expenditures decreases the political cost of fiscal consolidation. Inspired by the delegation of monetary policy, economists have also suggested that some decisions regarding fiscal policy should be delegated to independent experts. Most proposals suggest that decisions about the budget balance can be delegated to such institutions (Bertelsmann 2013; Calmfors and Wren-Lewis 2011; Debrun et al. 2009; Wyplosz 2005), but Blinder (1997) goes further and argues that specific tax rates should also be placed under expert rule. The euro area has gone furthest in this process. Since the implementation of the ‘six-pack’ in 2011, the Commission has been given the mandate to hand out fines to member states that do not follow the Council recommendations with regard to the budget balance and other sources of macroeconomic instability, including the unemployment rate, the unit labour costs and other highly political factors. Moreover, the delegation of monetary policy has also given independent authorities the last say on demand management, because monetary policy can be used to counter the effects of the government’s fiscal policy.

Common to all these institutions is the fact that they partly protect the policy makers from pressure from the electorate. In its simplest form, the idea is that by correcting for the deficit bias, policy will be closer to what is optimal for the majority of voters. While cross-national studies have shown that conservative fiscal frameworks increase fiscal discipline (Hallerberg et al. 2007), these institutions have not stopped the public debt from growing. The Great Recession caused public debt to reach unprecedented levels and as shown in Figure A, the aggregate net debt in the OECD now amounts to approximately 70 per cent of GDP. If anything, we can expect the reforms of the budget process and fiscal frameworks to continue. How far can this process go on? Are some reforms more important than others? I will soon discuss the possible drawbacks of institutions which might widen the gap between public opinion and implemented policy, but first I will examine the theoretical explanations for the popular resistance described above.
Understanding popular resistance

It is an old insight that unless perfect markets are disturbed by government invention, they will generate Pareto optimal outcomes – that is, no one can be better off except at someone else’s expense. Why then, have people throughout history counteracted the market mechanisms by legislated price levels, production stops and the cancellation of previous agreements? What caused the Mesopotamian peasants to favour a system that must have made it difficult to borrow money at reasonable interest levels, the people of Lisbon to favour price control before market prices, and the British workers to destroy machinery instead of moving to an employer that paid better? Was it the same reasons that were behind the wage-inflation-spiral during the 1970s and which now cause people in Greece and other debt-burdened countries to reject austerity measures?

It is obvious that people hold a non-market notion of social justice (Streeck 2011). However, it will always be contested to which degree these actions reflect a legitimate class struggle between the oppressed and their oppressors, the insiders’ protection from competition from others that are less privileged, or a sympathetic but counter-productive struggle against what most people perceive as inhumane and inappropriate. Functionally speaking, we can imagine four kinds of purposes for these anti-market actions. The first two are distributional, the third is caused by bounded rationality and the last corresponds to different kinds of social preferences. Below I briefly comment on the different options and the weight they are given in the public finance literature.

The first option is that the populace has engaged in a legitimate class struggle against their oppressors. In most cases, this corresponds to a
distributional conflict between buyers and sellers on a market, such as a labour market dispute between workers and employers. Class conflict is irrational on a perfect market, because market distortions make both buyers and sellers worse off. But as soon as a market is not perfect, for example because buyers have a monopolistic position or because the quantity of goods or services is limited, there can be a surplus to fight over.

This perspective is surprisingly absent from the fiscal sustainability literature, where budget deficits are typically analysed as an inter-temporal distribution of government consumption. That works well as long as governments are restricted to repaying their debt, but the possibility of default is fundamental to fiscal sustainability. Governments do default from time to time – the interest rate on government bonds is a sign of this – and when they do it has major distributional consequences. Defaulting on sovereign debt is definitely not a free lunch, but it is arguably more costly for the owners of government bonds. When the bonds are owned by other governments, governments in debtor countries are more negative towards fiscal consolidation than the creditor governments (Maatsch 2014). Moreover, expansive fiscal policy can also increase inflation, which has immediate redistributive consequences that differ between the wealthy and those in debt.

The second option corresponds to a distributional conflict between different groups of buyers or sellers, which arises because there are groups which do not internalize the consequences for actors outside their own group. This is the bearing assumption for many theories of political economy. We can easily apply the insider–outsider theory of Lindbeck and Snower (1988) to many pre-industrial labour markets, where guild systems, small villages and low labour mobility must have made it difficult for outsiders to underbid the insiders. As a result, insiders could receive wages higher than market wage without losing their job. Olson (1982) stated that a group will distort market outcomes when it is neither too small to be without power or too large to internalize the preference satisfaction of the majority. Calmfors and Driffill (1988) applied this insight to the labour market and argued that wages are higher than the market clearing level when unions are strong enough to influence wages but not united enough to internalize the societal costs of unemployment. Other examples include rent control on the housing market and other cases where the insiders prefer a queuing system instead of a market-clearing price.

There are also versions of this idea within the public finance literature. First, voters can exploit future generations – which of course cannot vote – by supporting large budget deficits and sending the bill to the future
The legitimacy and efficiency of economic-political institutions

There is a consensus among democracy theorists that some constraints on the majority rule, such as clear rules for the decision-making procedure, strengthen the democratic process. For the same reasons, it is obvious that
certain kinds of budget rules indeed strengthen the deliberative element of policy-making (Molander 2001). This is especially true for rules that make trade-offs visible and reduce the information advantage that governments exert over the voters. However, other fiscal institutions are difficult to defend on grounds other than that they improve fiscal discipline. These include institutions that are i) irreversible, ii) increase the information asymmetry between the incumbent and the public, iii) induce a political bias, or iv) institutionalize contested policies. Examples of such institutions are the fiscal rules of the European Union, where revisions require a consensus among all member states; the non-indexation of expenditures, which makes it easy for governments to obfuscate cutbacks; and expenditure ceilings, which introduce an asymmetry in the treatment of spending hikes and tax cuts as well as prevent a Keynesian reaction to economic downturns.

At the same time, fiscal indiscipline has time after time led to debt crises where agreements with creditors or even military coups have resulted in democratic deficits of an entirely different magnitude. So what kind of constraints should be placed on the popular influence on fiscal policy? If a consensus exists among economists on the optimality of these constraints, can they still be questioned for their democratic legitimacy? While the essays in this thesis are focused on questions related to the output side – e.g., is the democratic process to blame for fiscal imbalances? – we cannot assess the normative aspects of fiscal institutions unless we also consider the costs for imposing constraints on the majority rule. Most of the arguments in this section are equally true for other aspects of policy-making, like the delegation of monetary policy to independent central banks.

One of the main arguments in favour of democracy is that it produces good outcomes because elections provide voters the ability to throw out incumbents when they expect the challenger to be more competent, thereby incentivizing politicians to maximize public welfare (Healy and Malhotra 2013). Using such sanctioning and selection models, it is easy to theorize when the representative democracy yields the best outcomes and when it is better to delegate decisions to an independent authority. Among economists, Alesina and Tabellini (2007, 2008) and Maskin and Tirole (2004) have written the most influential texts about the normative aspects of policy delegation. However, they are exclusively concerned with policy outcomes, which makes it a trivial conclusion that ‘if society could write optimal performance contracts with its policymakers, /.../ bureaucratic delegation under an optimal contract would always dominate /.../ [and] there would be no need for elections or politicians’ (Alesina and Tabellini 2008).
While economists have analysed the normative aspects of policy delegation with a strong focus on the policy outcomes, most political scientists analyse constraints on democracy as a trade-off between two partly conflicting goals, e.g. *legitimacy* and *effectiveness* (Lipset 1959, 1960), *input legitimacy* and *output legitimacy* (Scharpf 1999, 2013) or *responsiveness* and *responsibility* (Mair 2009, 2013). Even if it were possible to delegate policy-making to a just and competent philosopher king, such a political process would lack democratic legitimacy and undermine the political system. I will briefly comment on three of the most common arguments for why output is an insufficient criteria – input legitimacy, deliberation and accountability.

Scharpf (1999, 2013) describes democratic legitimacy as a two-dimensional phenomenon. The *input* dimension concerns the congruence between policy choices and the salient preferences of the electorate while the *output* dimension is concerned with the degree to which outcomes attributable to the government satisfy the electorate’s preferences. Legitimacy in both these dimensions, Scharpf argues, is important for the support of the government and, ultimately, the democratic legitimacy of a political regime. However, the two dimensions can be in conflict with each other, and in order to ‘maintain output legitimacy through functionally effective policies, governments may need to employ instruments that undermine their input legitimacy’.

Scharpf’s argument points to an important reason why the successful delegation of monetary policy cannot easily be transferred to fiscal policy. Despite its stabilizing role and distributive effects, monetary policy is considered to be less salient than fiscal policy. Therefore, the delegation of monetary policy to independent central banks is less of a dilemma than the corresponding delegation of fiscal policy, simply because it has a smaller effect on the input legitimacy of democracy.

Another way of theorizing input legitimacy comes from Mair (2009, 2013). He describes the regulation of macroeconomic policy-making as a conflict between responsibility – a difficult concept related to efficiency as well the commitment to agreements and accepted procedures – and responsiveness – the degree to which government action follows the preferences of the electorate. Because of the increased importance of fiscal frameworks, obligations to international organizations and commitments to prior agreements, among other things, Mair argues that it has become increasingly difficult for governments to bridge the tension between responsibility and accountability.
responsiveness. Mair also claims that parties in government have become more responsible than responsive, or as Streeck (2011) puts it, ‘citizens increasingly perceive their governments not as their agents, but as those of other states or of international organizations, such as the IMF or the European Union’. The destiny of the Greek government under George Papandreou is an illustrative example. After close co-operation with the creditors, with little responsiveness to the Greek voters, his party, PASOK, went from holding 43.9 per cent of the votes in the 2009 elections to 4.7 percent in 2015.

Mair connects the lacking responsiveness of governing parties with the growth of populist parties. The more responsible the governing parties become – the more room there will be for opposition parties that promise to end fiscal consolidation, renegotiate terms with creditors and restore the country’s sovereignty. In the more extreme examples, such as Golden Dawn in Greece, such parties can even advocate the abolishment of democracy.

The second virtue of a democratic process is that it promotes deliberation and preference formation in the electorate. Follesdal and Hix (2006) go as far as to conclude that preference formation through deliberation and party contestation is what separates democratic rule from regulated benevolent authoritarianism. Claus Offe argues that non-participation in politics negatively affects preference formation (Offe 2011, 2013), making the opinions of those who do not participate ‘more ill-considered and unreflective’. The same argument could be used for whenever policy is removed from public debate. Deliberation is not only a matter of developing one’s own preferences, but also about fostering empathy with others and creating acceptance for their opinions.

The third argument in favour of the democratic processes concerns accountability, which can be defined as the possibility to replace the officeholders with other candidates (Gustavsson 2009). This minimalist definition is often expanded with the existence of a political opposition, making it possible for voters to identify alternatives and determine whether those in office are doing a good job. Needless to say, when policy is delegated to an independent authority, it is difficult for citizens to hold anyone accountable for implemented policy. This could entail increased discontent and disengagement with formal politics (Hay 2007). It could also create more space for populist opposition parties that do not feel obliged to honour the fiscal framework, while the traditional parties might be perceived as superfluous if they all subscribe to the same policies. In addition, if governments can blame the implemented policies on external constraints, they have even stronger incentives for advocating populist policies – not even in the long run can voters hold them accountable for the economic outcomes.
To sum up, there is a risk that more constraints on policy-making can weaken the input legitimacy, preference formation and accountability of our democratic system. This, in turn, can lead to reduced trust towards established parties, benefit populist parties, and reduce political participation – further decreasing policy responsiveness (Erikson 2015; Lijphart 1997). Admittedly, it is difficult to analyse these questions with a convincing identification strategy, and the theoretical support for these arguments is stronger than the empirical. But following a precautionary principle, less constraints on policy-making would always be preferred as long as they do not affect policy outcomes. Because constraints are likely to affect policy outcomes in a good way, this is a genuine trade-off. Trade-offs are seldom zero-sum games. By increasing our knowledge about the deficit bias, we can also learn more about what measures are needed to correct it. Applying ineffective or even counter-productive constraints will hurt legitimacy more than it improves fiscal discipline.

Contributions

This thesis consists of four essays which all contribute to the larger question of fiscal sustainability. In this section I will briefly summarize these contributions, focusing on the questions raised in this introduction. Each of the subsections broadly corresponds to one of the essays.

The electoral incentives for fiscal indiscipline

Conventional wisdom states that austerity policies are unpopular among voters and that those governments which implement cutbacks in social spending will lose votes in the subsequent election. But is it so? Can we be sure that voters punish governments, even if the latter only do what they think is right?

Most readers probably find it surprising that the assumption of a fiscally irresponsible electorate has received little empirical support. In fact, all attempts to test this claim have concluded that there is no electoral disadvantage for governments which implement fiscal consolidations and – in some cases – that voters even reward governments for fiscal discipline (Alesina et al. 1998, 2012; Breider 2003; Breider and Drazen 2008; Drazen and Eslava 2010; Lowry et al. 1998; Peltzman 1992). On the other hand, there are methodological problems with these studies, which call for a reassessment of the data. In my first essay, I claim that previous research has underestimated the true consequences for governments which implement fiscal consolidations. Contrary to the results of previous research, I find that voters indeed punish governments that implement large fiscal adjustments. This finding underlines the dilemma which arises when the
will of the people contradicts the consensus among economists or goes against previous commitments and international agreements. Should fiscal consolidations be implemented, even if the electorate wants otherwise? If so, how can we design institutions that reduce the electoral disadvantage for governments which implement unpopular policies?

While I find support for the assumption that voters punish governments for fiscal consolidations, the evidence is still not in line with the concept of a deficit bias. A deficit bias implies that budget deficits are larger than they would have been if policy had been decided by a benevolent social planner. The most common explanation of the deficit bias is that the incumbent government would be at an electoral disadvantage if it were to implement more conservative fiscal policy. There are several mechanisms which could explain the electoral incentives for a deficit bias. First, if voters care more about their own well-being than that of future generations, they can exploit the latter by voting for parties which run large deficits today and send the bill to future generations. Second, according to Olson (1982), concentrated minor interests are over-represented compared to diffuse majority interests. When public spending and tax subsidies are directed to concentrated interests, these interests will be more influential than the interests of those who eventually must pay for the reforms, which can cause the deficit to be higher than any of these interests would prefer (Velasco 2000). Third, voters might lack information about the public finances. If voters notice when they receive tax cuts and better services, but not when the government improves the budget balance, vote-seeking incumbents will not prioritize the latter. Last, voters might have time-inconsistent preferences, which causes them to react more positively to consumption today than consumption in the future.

All these mechanisms provide compelling arguments for why fiscally disciplined incumbents might be at an electoral disadvantage. As there is nothing in these mechanisms which suggests an asymmetrical relationship between fiscal policy and election results, we should expect governments to be rewarded for fiscal expansions and punished for consolidations. However, this is not what the data shows. According to the evidence presented in the first essay, voters punish governments which implement large fiscal adjustments, but they appear to be indifferent to small consolidations and fiscal expansions. Similarly, Ponticelli and Voth (2011) find that fiscal consolidations increase the probability of social unrest, but they do not find a similar decrease in instability following budgetary expansions. In other words, there are electoral incentives for fiscal profligacy, but only because voters oppose large consolidations.

These results suggest that there is an asymmetry in the popular resistance, such that people are more inclined to take actions to prevent any
worsening of their current position, than they are to demand improvements of their standard of living. Indeed, as illustrated by the anecdotes in this introduction, history is packed other examples of how popular resistance has not arisen before economic or social conditions have deteriorated. As long as the economy has performed well, opportunistic and market distorting behaviour has been relatively uncommon. When new machines were introduced during times of rising prosperity, they were not faced with much resistance (Hobsbawm 1952, p. 63). And during the golden decades after World War II, inflation was low, public finances were in good shape and there were only a small number of labour market disputes. But when the oil crises hit, labour unions took a stand against wage cuts and the number of strikes skyrocketed. At the same time, inflation had begun to accelerate and it did not take long before governments started to accumulate large levels of debt.

While there are many theories which can explain high inflation, large deficits and why wages are higher than market wages, most of them cannot account for why we do not observe the same phenomena during more stable times. For example, intergenerational exploitation could explain the lack of fiscal discipline observed in many countries. However, if voters seek to exploit future generations, why were debt levels not rising during the 1950s and 1960s? And why are there no electoral rewards for governments which implement fiscal expansions? To understand such contextual differences, I believe we must consider the fourth category of market resistance: social preferences.

Public debt and morals

We have now established that, on average, governments which implement fiscal adjustments lose votes in the subsequent elections, compared to governments which do not improve the budget balance. In other words, there appear to be electoral incentives for fiscal irresponsibility. But as argued above, this finding is difficult to reconcile with the concept of a general deficit bias, because people’s acceptance of fiscal consolidation differs so much between contexts and situations.

During the second world war, half of the American population bought war bonds issued by the government. The bonds had a rate of return below the market value, but people bought them because it was the right thing to do. When others risked their lives at the front, those at home felt obliged to contribute in other ways. During the winter of 1944, the most common New Year’s Resolutions were to improve one’s character, go to the church more often and buy more government bonds (Gallup 1972).

In other situations, people have been much less willing to pay for government expenditure. As shown in the first essay, governments which
implement large fiscal consolidations are often punished in the subsequent elections. How is it possible that the 1944 Americans were ready to personally lend money to the government – which was even seen as a civic virtue – while in other situations, voters have found it unacceptable that the government raises taxes or cuts spending to reduce the country’s debt?

From the earthquake in Lisbon to the resistance against wage cuts, I have presented many examples of how people resist market outcomes that they perceive as unfair. And if you ask people for their opinion on fiscal consolidation, you can be almost sure that they will answer you with a moral argument. However, fairness and other kinds of morality are virtually absent from the public finance literature. In the essay ‘Not my problem – fairness and fiscal responsibility in the age of austerity’, Rafael Ahlsgkog and I propose a new explanation for why voters may oppose fiscal consolidations. Our claim is that citizens are more willing to accept fiscal consolidations when they feel a responsibility for the public debt.

Responsibility is closely linked to the attribution of blame (Sahar 2014). When citizens feel partly responsible for the debt, or perceive that it was accumulated for a greater good, they are more likely to accept that they must pay a part of the cost when the debt is to be repaid. We apply this assumption to the consequences of banking crises and argue that voters are more likely to be opposed to fiscal consolidations if the fiscal problems are caused by large bailouts to the banks.

We use three different kinds of evidence to test our claim. First, an analysis of cross-national data shows that governments are punished hard for fiscal consolidations if there have been any large and recent bank bailouts. We find no electoral consequences of fiscal policy in periods without bailouts. Second, we conduct a survey experiment where we provide respondents with different information about the reasons for the public debt. One third of the respondents were informed that the debt was caused by a bailout to the banks. The other respondents were either not given any reason for the fiscal problems, or were informed that the debt was accumulated because the government ran a budget deficit over several decades. The respondents were then asked about their opinion on implementing a mix of tax hikes and spending cuts to start repaying the debt. The results support our hypothesis. When the banks are blamed for the fiscal problems, the respondents were more negative towards fiscal consolidation than when the fiscal problems were blamed on budget deficits which were accumulated over decades. Third, we categorize the free-text answers which the respondents used to motivate their opinion on fiscal consolidation. Among those who were told that the debt problems were caused by a crisis in the banking sector, it was much more common to argue that the debt was not the responsibility of the respondent or the (American) people.
But what can we learn from these results, other than that governments should think twice before implementing fiscal consolidations shortly after a large bank bailout? For the problems discussed in this introduction, the most important question is probably how people’s sense of responsibility is affected by their influence over fiscal policy. When things go wrong and a need for fiscal consolidation arises, do people feel more responsible if fiscal policy has been debated in the election campaigns? It is common for governments to use the central bank as a scapegoat for labour market outcomes (Alesina and Stella 2010). Will the electorate support fiscal consolidation, if the government blames the problem on international organizations like the IMF and the EU? Until more research is conducted on this topic, we can only speculate. But as soon as people’s actions are affected by their moral sentiments, it becomes much more difficult to design institutions which yield optimal incentives for the desired outcomes (Bowles and Hwang 2008).

**Politics or perceptions?**

The first two essays show that it can be costly for governments to implement large fiscal adjustments, but why do governments put themselves in these difficult situations? None of the essays find that there are electoral incentives for governments to accumulate debt through expansionary policy. Arguably, the problems would be small if governments consolidated public finances during times of favourable economic conditions.

In the third essay, titled ‘Politics or perceptions’, I argue that many governments have also accumulated debt during favourable times, simply because the policy makers and their economic advisers perceived the situation as less favourable than it actually was. If governments believe that the economy is in a temporary downturn and that the economic situation will improve in a few years time, their fiscal policy will be more expansive than if they had believed that they were at the peak of the business cycle. There are two reasons for this connection between perceptions of the economy and implemented policy. First, if the government believes in counter-cyclical fiscal policy, it will implement expansionary policy to bring output back to its potential level. Second, if they believe that the economic situation will improve, they will also assume that the budget balance will improve automatically when the economy improves, and therefore underestimate the need for discretionary action.

The decade preceding the Great Recession was characterized by fast growth and low unemployment. In retrospect, governments should have used this opportunity to consolidate public finances. However, these years were not perceived as an economic upturn at the time when the budgets were passed. On the contrary, independent experts consistently assessed
that output in most OECD countries was slightly below its long-run trend. For this reason, policy advice given by international organizations like the IMF and the European Commission was also very lauditive about many countries’ half-hearted attempts at consolidating finances, compared to the harsh criticism delivered to them after the financial crises struck.

Orphanides (2001, 2002, 2003) and Orphanides and Williams (2004) find similar results with regard to the conduct of monetary policy during the Great Inflation. They argue that a persistent downward shift in productivity led to misperceptions about the economy’s cyclical position, which in turn resulted in overly expansionary policy and accelerating inflation. This view of the Great Inflation as an ‘honest mistake’ stands in sharp contrast to those who argue that policy-making suffered from an ‘inflation bias’ (Barro and Gordon 1983b).

Do my results imply that there is no deficit bias in fiscal policy? I previously defined a deficit bias as a setting where deficits are larger than they would have been had policy been decided by a benevolent social planner. However, it is difficult to test this claim, because we do not know what fiscal policy would have looked like had it been conducted by independent experts. And compared to monetary policy and inflation, it is more difficult to evaluate the conduct of fiscal policy. But at the least, we can conclude two things. To begin with, honest misperceptions about the economic situation can account for a large part of the lack of fiscal discipline during the 1996–2012 period. Moreover, the results imply that fiscal problems are not in themselves sufficient proof that something is wrong with policy-making. When debt grows to unsustainable levels, it can also be the result of honest but unfortunate mistakes.

**De-indexation and fiscal outcomes**

The sustainability of public finances is more challenging today than ever before, with debt in most countries being on unsustainable trajectories (Bertelsmann 2013). As I show in my first essay, it is unlikely that governments can revert this trend without facing electoral losses. How should we understand these challenges that governments face? What can be done to reduce the electoral consequences of fiscal adjustments?

The ‘new-politics’ approach to the welfare state research is based on the claim that welfare state retrenchment is different from welfare state expansion because it requires incumbents to implement unpopular policies (Pierson 1996). In contrast to the credit-claiming efforts of welfare state expansion, the capacity to pursue austerity politics is determined by the

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12The largest difference between fiscal and monetary policy is probably that the stock of debt is more important in fiscal policy than the price level is for monetary policy.
potential to lower the visibility of the reforms (Pierson 1996; Weaver 1986).

The least visible cutbacks are probably those which do not require discretionary actions. When expenditures are formulated on a nominal basis, governments can allow inflation and wage increases to erode the value of benefits and transfers (Green-Pedersen 2002; Lindbom 2007; Pierson 1994). In line with this kind of obfuscation, the results in my first essay show that the electoral consequences are smaller if fiscal consolidation is implemented during times of rapid growth.

Further de-indexation of public expenditure has recently been proposed as a ‘less painful’ strategy to improve public finances (Marcel 2014). By making it easier for governments to obfuscate cutbacks, de-indexation is probably good for fiscal discipline, but it comes at a cost.

The first problem with de-indexation is that it might hurt the input legitimacy of fiscal policy, as it decreases the transparency of the budget process. During the last decade, both the OECD and the IMF have emphasized the importance of fiscal transparency to improve the sustainability of public finances. Transparent budget processes are thought to improve fiscal rectitude because they increase the political risks of unsustainable policies and make it difficult to hide fiscal profligacy from markets and voters (Craig and Kopits 1998). As long as it both improves fiscal discipline and increases voters’ information about implemented policy, it is easy to argue in favour of increased fiscal transparency. However, some aspects of the budget process would most likely reduce fiscal discipline if they were made more transparent. This is particularly true for the indexation of public expenditures, which would make it difficult for governments to hide cutbacks from voters. This could be the reason why neither the OECD’s ‘Best Practices’ (OECD 2002) or the IMF’s ‘Fiscal Transparency Code’ (IMF 2014) require that governments disclose information about how the real value of existing programmes are deflated.

The second problem is that de-indexation can distort policy outcomes. In the fourth essay, titled ‘Economic growth is deflating the welfare state’, I argue that economic growth has eroded the value of both public transfers and services in many countries. As a consequence, countries with rapid growth have reduced the size of their public sectors. In fact, differences in economic growth can account for large parts of the cross-national variation in welfare state development over the last two decades. In other words, while de-indexation can improve fiscal discipline, it might affect the size of the public sector in a direction that has not been chosen by voters.

This situation creates a dilemma, because consolidating public finances is one of the most challenging tasks that governments face. It is therefore important that we can develop institutions which facilitate budget im-
provements without distorting effects in politically contested areas. One such possibility would be to combine de-indexation with medium-term targets for the tax ratio. If governments would like to use the fiscal space on tax cuts, they would have to change their tax targets. A second possibility is to increase the share of temporary spending with so called sunset clauses. Such explicitly temporary expenditures are probably best suited for counter-cyclical policy during economic downturns.

Conclusions

There is an ongoing tendency toward the depoliticization of fiscal policy, with an increased reliance on independent fiscal institutions and constitutional balanced-budget requirements (Fernández-Albertos 2015). This trend is strongest in the European union, where fiscal decisions are now monitored by supranational authorities. The depoliticizing tendency is not without a reason. Indeed, the fiscal problems of OECD countries are worse than ever before, and the ongoing debt crisis has demonstrated the consequences for countries which lose control over their public finances. Moreover, the euro has increased the interdependence of European economies and increased the costs for imbalances between countries.

At the same time, many democratic theorists worry about an increasing citizen distress in established democracies. Political participation as well as trust in the democratic institutions has fallen (Pharr and Putnam 2000). This, in turn, has worsened inequality in political responsiveness (Erikson 2015) and increased the over-representation of people with high incomes and conservative attitudes (Hacker and Pierson 2010). Colin Crouch argues that we are moving towards a post-democratic society, where the impotence of egalitarian politics and the trivialization of democracy is transforming democratic institutions to a formal shell (Crouch 2000, 2004). According to Crouch, the treatment of the eurozone crisis is a good example of how politics works in a post-democracy (Crouch 2013). There are no quick fixes to this dilemma, but by carefully analysing the causes behind our fiscal and democratic deficits we can hopefully strike a better balance in the trade-off described above.

Taken together, the results in the first three essays have made me sceptical to the fruitfulness of deficit bias as an analytical concept. A bias usually denotes a distortion that is always present. Indeed, all the common explanations for fiscal indiscipline provide incentives for the government to consistently let the budget balance deviate from optimal policy. Why, then, was fiscal discipline so strong during the three decades after the

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Sunset clauses provide a date for when a law, a tax reduction or spending item will cease to exist.
second world war? Arguably, the case for exploiting uninformed voters and future generations should have been much larger when independent central banks could not counteract expansionary policies and the debt was too small for financial markets to worry. Instead, as I find in the first essay, the electoral incentives for a deficit bias are asymmetrical, so that voters oppose large fiscal consolidations but are more or less indifferent to fiscal expansions or small fiscal consolidations. This result is difficult to reconcile with the theoretical arguments usually suggested for why fiscally disciplined governments are at an electoral disadvantage.

The second essay investigates one reason why voters behave differently in different contexts. Ahlskog and I find that voters are more positive to fiscal consolidation if they perceive they have a responsibility for the public debt. We also find that large bank bailouts are one way of reducing that feeling of responsibility. This kind of moral argument is virtually absent from the public finance literature, but I believe that we must understand how moral sentiments affect attitudes if we want to explain the variation in citizens’ degree of fiscal responsibility.

In the third essay I argue that fiscal imbalances would arise even if fiscal policy was governed by independent experts. The reason for this is that we have a tendency to perceive slowdowns caused by structural changes as temporary downturns, while economic upturns are perceived to be the normal state of the economy. Because such misperceptions are more likely when the economic situation changes, this is also a potential explanation of why debt in most countries did not start to grow until the 1970s.

To me, it is obvious that fiscal policy has been too expansive on average, but that this tendency is better understood as a set of specific problems than as a permanent bias in the political system. These include resistance to large fiscal consolidations and an unwillingness to pay for things one is not responsible for, as well as systematic misperceptions about the business cycle. But what does that tell us about how fiscal policy should be conducted? I will end this introduction by briefly commenting on some of the dilemmas we face when designing fiscal frameworks and other institutions.

It is increasingly common to base fiscal policy on indicators of what the budget balance would be during normal economic circumstances. For example, the European Stability and Growth Pact requires countries to define their medium-term budget targets in structural terms. Such practice has strong theoretical appeal, but these indicators are difficult to calculate. And as shown in the third essay, biased perceptions about the economic situation will cause the structural budget balance to look better than it actually is. I therefore find it unlikely that fiscal frameworks that are
dependent on forward-looking budgetary rules and estimates of structural balances will improve fiscal discipline.

While a deficit bias in the traditional sense could easily be solved by forcing the incumbent to follow a forward-looking rule for the budget balance, it would not eliminate misperceptions about the economic situation and other kinds of honest mistakes. According to my results, even independent experts would periodically accumulate more debt than optimal. This is an argument in favour of general fiscal prudence and some sort of correction mechanism for previous mistakes. The latter can be achieved through backward-looking indicators of the budget balance or even targets for the debt level.

Most important is perhaps that we humbly acknowledge that governments will continue to accumulate large levels of debt, even if we manage to improve fiscal discipline. For example, both Iceland and Ireland spent more than 40 per cent of GDP on their recent banking rescues. A major war would cost much more than that. Fiscal shocks of that size can cause an immediate need for fiscal consolidation. And as shown in the first essay, governments might be at an electoral advantage if they choose to delay such adjustments. So how can we increase our capacity to handle a sudden increase in debt? As highlighted by the results in three of my essays, we here face two dilemmas.

First, a common tactic to reduce the electoral consequences for cutbacks is to allow growth and inflation to erode the real value of expenditures. Indeed, in my second essay I find that the electoral costs for fiscal adjustments are smaller during periods of fast growth. However, such obfuscation measures come at a cost. As I argue in my fourth essay, a budget process where expenditures are set in nominal terms may increase fiscal discipline, but it will also distort the size of the public sector from what it would have been had the electorate made an informed decision.

Second, Ahlskog and I find that responsibility for the public debt is fundamental for citizens’ willingness to support fiscal consolidation. But how is this sense of responsibility affected if fiscal policy is based on rules or decided by independent experts? Is it possible that the gap between the citizens’ policy preferences and the views of economic experts will widen, if fiscal policy is brought further away from immediate popular influence? Are there measures we can take to improve fiscal discipline with the support of the people? Lipset (1959) argued that democratic legitimacy determines a country’s capacity to recover from recessions and lost wars. Improving fiscal policy while maintaining its legitimacy is one of the largest challenges we face today.
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