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Economics or Politics? A Theoretical Review of the Determinants of Fiscal Policy

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Abstract

This article reviews the latest contributions in the literature of fiscal policy and highlights different economic and political factors that explain why fiscal policies in general and fiscal adjustments in particular vary between countries and along time.

Among the economic determinants of different fiscal policies and fiscal adjustment strategies, the article focuses on the role played by three groups of factors: the economic cycle and the unemplyment rate, the level of prices and accompanying monetary conditions, and the accumulated level of debt.

And with respect to the effect that political constraints have on fiscal policy decisions, the emphasis is made on three additional sets of factors: the degree of fragmentation in decision-making, the role of elections, and the effect of the government's ideology on economic-policy making.

Keywords: Fiscal Adjustments, Political Economy.

JEL Classification: C4, E6.

Resumen

Este artículo recoge y analiza a las últimas aportaciones a la literatura de la política fiscal y destaca diferentes factores económicos y políticos que explican por qué las políticas fiscales, en general, y los ajustes fiscales, en particular, divergen entre los distintos países y varían a lo largo del tiempo.

Entre los distintos determinantes económicos de las políticas fiscales y las estrategias de ajuste fiscal, en el artículo se ha optado por estudiar el papel de tres grupos diferentes de factores: el ciclo económico y la tasa de paro; el nivel de precios y las condiciones monetarias; y el nivel acumulado de la deuda.

Y con respecto al efecto de las restricciones de orden político en las decisiones relativas a la política fiscal se pone el énfasis en otros tres conjuntos de factores: el grado de

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fragmentación en la toma de decisiones, el papel de las elecciones y el impacto de la ideología del gobierno en la política fiscal.

Palabras clave: Ajustes Fiscales, Política Económica.

Clasificación JEL: C4, E6

"A crude distinction between economics and politics would be that economics is concerned with expanding the pie while politics is about distributing it." (Alesina and Rodrik, 1994: 465)

1. Introduction

Since 1999, those European governments who joined the single currency can only use fiscal policies to affect the economy. With this single policy instrument, national governments are still responsible for guaranteeing the reallocation of resources, the stabilization of the economy, and the redistribution of income. In addition, fiscal policy is still fully responsible for increasing or decreasing the size of the public sector in the economy, for smoothing or accentuating the effects of economic recessions, and for implementing long-run policies oriented towards increasing the growth potential of the economy. Apparently, too many functions for a single and constrained policy instrument.

Nevertheless, despite the restrictions imposed by supranationalized monetary policy, the Maastricht criteria, and the Stability and Growth Pact, fiscal policies seem not to be that constrained, since they have not converged in Europe to quasi-full coordination as required by monetary union. Why is it so? Why fiscal policies did not converge in the past decades as new steps were taking place towards full economic and monetary integration?

Moreover, joining the euro required from most countries the implementation of considerable fiscal adjustments (1), but not all countries implemented the same adjustment strategy. For example, some countries chose to reduce their budget deficit gradually through successive short fiscal consolidations (like Finland or the Netherlands), while others preferred to pursue fewer but longer adjustments (like Greece or Ireland) (2).

Those episodes of fiscal adjustment not only varied in the strength and duration of the consolidation strategy, but they also greatly varied in the composition of the adjustment (3). For example, between 1970 and 2000, countries such as Ireland have

(1) Some countries really made a tremendous effort to qualify for the third phase of EMU. For example, in only four years, between 1993 and 1997, Sweden reduced its deficit by11.4 percentage points of GDP, Finland by 7.1%, Italy by 6.8% and the United Kingdom by 6.8%. The deficit reductions in the rest of member states were as follows: Belgium 5%, Spain 4.7%, Portugal 3.6%, France 2.8%, the Netherlands 2.6%, Austria 2.7% and Germany 0.7%. Among the countries that already fulfilled the deficit criterion in 1993 because they had consolidated their budgets in the eighties, Denmark improved its budget balance by 3.5% and Ireland by 3.6%. Luxembourg maintained its superavit during the whole period. (EC, 1998: 93)

(2) The comparison between Greece and Germany is very illustrative of this variation. While Greece has been involved in short but recurring fiscal adjustment strategies during 16 years of the last 30 years, Germany has only been involved in consolidation episodes during 4 years.

(3) For a description of the three dimensions of fiscal adjustment strategies (timing, duration and com-

shown a clear preference for expenditure-based fiscal adjustments, while others such as Austria have only undertaken revenue-based consolidations.

More recently, in the run-up to EMU, this variation in the composition of fiscal adjustment strategies was not only maintained, but even increased. While some member states decided to follow revenue-based strategies (France, Greece, or Italy), others decided to follow expenditure-based consolidation strategies (Denmark, Sweden, or Finland). Expenditure-based strategies of adjustment also varied in the degree by which current and capital expenditures were cut. Finally, a group of countries (Austria, Belgium, or the Netherlands) switched their strategies in the middle of the fiscal consolidation episode, in view of the relatively low success of their initial strategy. This change in the consolidation strategy typically implied additional spending cuts once the sole reliance on revenue increases had proved insufficient to achieve the overall fiscal target.

Given this historical evidence, how can we explain that different countries followed different adjustment strategies, if they all had to fulfill the same deficit criterion of 3% of GDP? What are the economic and political factors that influence fiscal policy and fiscal adjustments?

The answer to all these questions has been already addressed in a purely empirical manner in previous works (4). Many related aspects will be also empirically studied in different articles of this volume. Nevertheless, it is obvious that a variety of crucial theories lie behind empirically testable hypotheses regarding the determinants of fiscal policies and fiscal adjustments. And this is precisely the objective of this introductory article: to summarize and present in a systematic way this abundant theoretical framework.

Therefore, in order to review how the literature has approached the questions and concepts raised above, the article will proceed as follows: the next section will describe and put together the main economic determinants of fiscal policy and fiscal adjustments. Since many times economic theories have proved insufficient to explain fiscal policy, the third section will present and discuss the politico-institutional factors that are likely to affect the formulation of fiscal policy. Finally, section 4 will summarize and conclude.

2. The Economics of Fiscal Policies and Fiscal Adjustments

The theoretical and empirical literature on the economic determinants of fiscal policy is so extensive that it would be impossible to even have a brief account of all major contributions in this section.

This is so because whether or not governments should intervene in the economy using the monetary and fiscal policies available to them has been the central topic of strong debates among economists and politicians during the last century.

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position) and an empirical analysis of their determinants, see Maroto and Mulas-Granados (2002), and Mulas-Granados (2003). For the effects that alternative adjustment strategies [increases in revenues vs. spending cuts) have on their sustainability and on economic growth, see for example: Alesina and Perotti (1997), Alesina and Ardagna (1998) and Von Hagen, Hallett and Strauch (2001)].

(4) See for example, Maroto and Mulas-Granados (2002) and Mulas-Granados (2003).

Those who think that economic fluctuations arise from exogenous shocks in the economy, mainly on the supply side through changes in technology, and those who think that shocks in aggregate demand are caused by misguided monetary policies, are opposed to government intervention in the economy. Monetarists and neo-classical economists sustain that the market will provide the best possible solution to any change in the economic environment, thus impairing the effectiveness of policy instruments. Based on rational expectations, they believe that private actions will offset in the medium-run any governmental intervention in the economy. By assuming that the Phillips curve (the curve that relates inflation and unemployment) is vertical, they affirm that any attempt by the government to stimulate the economy, will only increase the price level, getting nothing in return. According to their view, if impediments for full market functioning are eliminated, actual output will tend to potential output, and the economy will progressively reach its natural rate of employment. At that point, the most the government might be able to do is to reduce the unemployment rate below the natural rate for a short period of time. But the cost in terms of increased inflation will be so big that the best choice is not to intervene in the economy.

On the other hand, there are economists who sustain that economic fluctuations are inherent to the capitalist system and reflect the normal process of investment-production cycle (5). These economists, together with Keynesian economists, which see economic slowdowns as originated by insufficient aggregate demand, think that government policies can positively influence economic growth. They do not believe that the market economy is always able to absorb and respond to shocks, so that full employment is maintained. For them, even with rational expectations, some government policies can have large effects, because wages and prices are not as flexible as new-classical economists affirm. These rigidities cause market failures that governmental intervention can solve. But, according to this view, even if the functioning of markets was perfectly efficient, the government would still have a role to play in providing public goods (6), in affecting the decisions of consumers and firms through tax policies, investment credits, and welfare spending. Governments may be willing to affect market mechanisms to correct for some imbalances among productive sectors of the economy, or most importantly to affect the distribution of income.

According to Notermans (2000), the general prevalence of one or the other type of approach to economic policy, allows to identify three economic regimes. Until the 1920s, the liberal regime of the gold standard with a pure floating exchange rate system was purely non-interventionist. This gave rise to a progressively regulated economy from the thirties on, and especially from the fifties until the mid seventies. These two first decades of the postwar period witnessed the golden age of Keynesian inter-

(5) "The way of relating business cycles to the internal working of the economy is called the multiplier-accelerator model, first developed by the Nobel Paul Samuelson" (Stiglitz and Boadway, 1994: 1090).

(6) "Public goods are those goods that it costs nothing extra for an individual to enjoy (their consumption is nonrivalrous), and that it costs a great deal to exclude any individual from enjoy them (they are nonexcludable). The standard example of a public good is defence." (Stiglitz and Boadway, 1994: 181). Because of their characteristics, the private sector would not supply most of those public goods, and it is the public sector who has to provide them, and finance their provision through public taxation. The theory of public goods in fact provided a new justification for government intervention in the production process of capitalist systems, because those goods were needed by the society but not provided by the market.

ventionist economics. However, after the oil shock of the mid seventies and the subsequent stagflation period, economic policy formulation turned again to be under full neo-classical non-interventionist dominance, and it remains so today.

Due to the complexity and the numerous implications that the previous debate has for fiscal policy in general, this section will only focus on those factors that can indeed be crucial to understand fiscal adjustment strategies, in particular. These factors can be grouped in three sets of determinants: (1) the economic cycle and the unemployment rate: (2) the level of prices and accompanying monetary conditions, and; (3) the accumulated level of debt.

2.1. Economic Cycle and Unemployment Rate

The economic cycle affects the budget on the revenues' side and on the expenditures' side. If the economy is booming, firms will be increasing their profits, and public revenues will increase via growing tax revenues. In that situation, more employment will be created and the State will see its unemployment subsidies charges reduced. The effect of an economic downturn will be exactly the opposite, and that is why fiscal adjustments tend to take when the economy is doing well, and rarely take place during recessions.

But the output gap (the distance between the actual output and the potential output) not only is important for the timing of fiscal adjustments. It can also have a crucial effect in determining the duration and the composition of adjustment episodes. According to Von Hagen, Hallett and Strauch (2001) a large output gap increases the likelihood of fiscal adjustments being started, but reduces the likelihood of the consolidation being long-lasting. In addition, if bad economic initial conditions coincide with high debt-to-GDP ratios, the likelihood of the adjustment being expenditure-based increases.

Nevertheless, it is important to note here that this effect of the economic cycle on the budget deficit through automatic stabilizers is very important in European countries because they have very developed welfare systems and tax revenues coming from direct taxation constitute their biggest source of public revenues. But this is not the case everywhere. For example, in less developed countries the effect of the economic cycle at home is not an important factor affecting public revenues, because these countries obtain most of their public resources from customs revenues, indirect taxation, and grants from multilateral organizations. Under such circumstances, the budgetary impact of the economic cycle is not even taken into account among the group of important explanatory variables of fiscal policies in those countries (Gupta, Clements, Baldacci, and Mulas-Granados, 2004).

The impact of the cycle on the public finances of advanced economies is so important, that every study willing to assess the evolution of discretionary fiscal policy needs to arrive at figures of the budget stance which are cyclically adjusted. In fact, most reforms to the Stability Pact proposed by eminent scholars and under study by the European Commission, introduce different types of mechanisms that could account for the effect that the cycle has on the deficit figures (an effect that is not currently discounted for the calculations of the deficit threshold).

2.2. Prices and Monetary Conditions

Fiscal policy and monetary policy are interrelated, and the policy-mix between both influences decisively the level of output, prices and interest rates in the economy. Imagine a situation in which the economy has been hit by an external shock in the prices of primary inputs that affects the final prices of most products in the economy. In such an inflationary scenario, the Central Bank would tend to tighten monetary policy, by increasing interest rates or by appreciating the domestic currency, in order to prevent prices spiraling out of control. Under such circumstances, there is empirical evidence (Mélitz, 1997) showing that fiscal policy tends to relax when monetary policy tightens. This can obey to various reasons: to compensate the contraction effect on output by implementing a fiscal expansion, or just because high interest rates make new public debt titles more attractive for private investors and, thus, obtaining private financing of public works becomes easier for the government. Due to this "compensation mechanism" between fiscal policy and monetary policy, there are some authors that sustain that monetary easing can induce governments to reduce budget deficits (Mélitz, 1997; Wyplosz, 1999). In fact, recent empirical evidence supports the mentioned hypothesis, according to which easing monetary policy in year t increases the likelihood of starting a fiscal consolidation in year t+1 (Von Hagen, Hallett and Strauch, 2001), as well as its likelihood of success (Lambertini and Tavares, 2001).

But these authors have also provided evidence that points toward a weakening during the nineties of the impact that these variables have traditionally had on fiscal policy. "Instead, fiscal policy became [in the last decade] less responsive to economic and monetary policy circumstances, and thus may have been driven more strongly by efforts to achieve fiscal surpluses for other reasons, namely to fulfill the Maastricht criteria." (Von Hagen, Hallett and Strauch, 2001: 59).

2.3. Debt Accumulation

Finally, the effect of accumulated debt on fiscal adjustment strategies is also very important. Even more so, if during periods of economic expansion, budgetary surpluses are not used to reduce the accumulated level of debt. In these cases, the debt burden will increase up to a point in which interest payments associated to the repayment of that growing debt will consume most of the share dedicated to public expenditures, in such a way that may finally end up rendering useless any governmental attempt to influence the economy through fiscal policy (7).

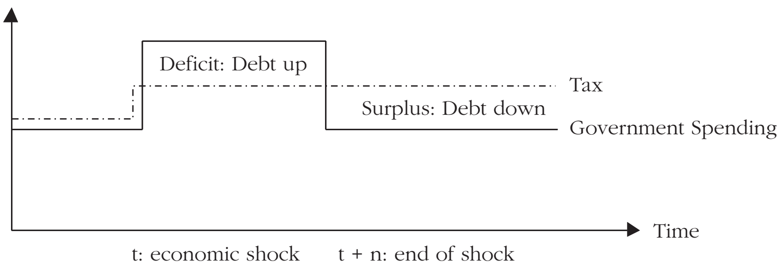
(7) In fact, the current anti-globalization movement postulates, among other things, the forgiveness of the developing countries' foreign debt, because the size of their debts prevents them from launching any domestic public initiative to generate growth and alleviate poverty.

The effect of economic shocks on the budget and the subsequent generation of debt, was first modelled by Robert Barro in 1979. Barro's tax-smoothing theory of the government's budget can be summarized as follows. Imagine that a government has a certain expenditure plan that is to be financed by distortionary taxes (8). But the government wants to minimize the distortionary effect of those taxes, so it confronts a decision in which it has to choose the optimal tax policy that enables it to finance the government's spending plans, at the same time that minimizes the loss associated to its distorsionary effect. The famous result of Barro's theory is that the optimal fiscal policy that minimizes tax distortions is a constant tax rate over time. This tax rate is then a function of the permanent level of spending, and the public debt can be explained as a "distortion smoother" and a "shock absorber" (Grilli, Masciandaro and Tabellini, 1991: 342) (9). Establishing this constant path, deficits generated during periods of decreasing revenues and growing expenditures (typical of adverse economic shocks), should be financed issuing debt. This debt will be cancelled during times of better economic conditions, when budgetary surpluses, will be generated (10).

According to the theory's postulates, tax rates must not be changed when temporary shocks occur, but only when permanent conditions in the economy change.

FIGURE 1

TAX-SMOOTHING MODEL



Source: Own elaboration.

This economic theory presents very clearly the sources of public deficits and surpluses, as well as it associates public debt generation to cyclical smoothing. It is im-

(8) Taxes can be lump-sum taxes or proportional taxes. In fact most taxes in real life are proportional taxes. These taxes are distortionary from the efficiency point of view, because they affect the efficient consumption decision and generate a loss of consumer's utility, but they are preferred to lump-sum taxes because they are superior from an equity perspective. Barro's starting point for his research was his observation that "proponents of the Ricardian view that the choice between debt and taxes (to finance the budget deficit) does not matter are left with an embarrassing absence of a theory of public debt creation" (Barro, 1979: 940). In fact the Ricardian equivalence between taxes and debt was based on the assumption that governments raise lump-sum taxes.

(9) In De Wolff (1998: 14).

(10) For a detailed formal presentation of the tax smoothing theory, see Roubini and Sachs (1989a).

portant to note at this point that the Barro's tax-smoothing theory borrows some important elements from alternative theories about optimal fiscal policies, such as the pro-cyclical and the counter-cyclical theories of fiscal policy.

The main difference between Barro's theory and the other two is the following: the pro-cyclical fiscal policy theory says that the optimal fiscal policy is the policy that maintains a balanced budget by adjusting public spending to the fluctuation of public revenues and the economic cycle; The counter-cyclical fiscal policy theory proposed by Keynes advocates in favor of increasing public spending during times of recession in order to spend out of the recession and go back to a situation of economic growth when public revenues will be higher than public expenditures and new surpluses will be generated to repay the debt generated by the deficits created during the recession. In this respect, the new contribution made by Barro was to advocate in favor of a constant tax over time in a Keynesian framework of counter-cyclical fiscal policies.

This theory seems to provide a very convincing explanation for at least part of the observed variation in fiscal policies in Europe between 1960 and 2000. The tax-smoothing theory is very useful to understand, for example, why after the oil-shock of 1973 debt-to-GDP ratios increased in all Western economies. At that moment, the shock was interpreted as a temporary one, and deficits generated by the shock were financed issuing new debt. In addition, if periods of deficit, in Figure 1, are considered as episodes of fiscal expansion, and periods of surpluses are considered as episodes of fiscal adjustment, then the theory provides also an explanation for the economic determinants of fiscal adjustments.

But what this economic theory cannot explain is why after the eighties, when it was already assumed by most economists that the shock had permanently affected the structure of the economy, debt continued to accumulate (11). The theory cannot explain either why do we observe in the last three decades extremely different levels of debt (in a range that goes from an average of 25% of GDP in Finland, to over 100% in Belgium, for example), in cases where those economies are extremely interrelated to each other, and had been impacted by economic cycles of very similar strength and timing.

This economic theory cannot explain why different countries present different composition of their revenues and expenditures, and why during episodes of fiscal adjustment some countries decide to increase taxes, while others decide to reduce expenditures.

Finally, it cannot account either for the persistent tendency to run pro-cyclical fiscal policies in the last 30 years. Instead of reducing government deficits during periods of economic growth, governments have been launching expansionary fiscal policies. This has impeded counter-cyclical smoothing, because in these circumstances governments have been forced to reduce deficits during economic recessions to prevent deficits and debt spiralling out of control. "Fiscal policies have thereby amplified the effects of cyclical swings in a pro-cyclical way rather that having the desired stabilizing

(11) The tax-smoothing hypothesis has been empirically rejected several times, at least for the period after 1973. For a review of these empirical tests see Roubini and Sachs (1989a).

effect" (EC, 2001: 7). This, pro-cyclical behaviour is especially illustrative of the rigidities of the budget, and it is an example of how political leaders find it easier to justify a fiscal adjustment during bad times.

But most importantly, the previous comments on the shortcomings of the economic theory to explain the observed variation in fiscal policies, opens the door to explore the political determinants of fiscal policies and different strategies of fiscal adjustment.

3. The Politics of Fiscal Policies and Fiscal Adjustments

The introduction of political factors into the analysis of budgetary processes aims at arriving at a deeper understanding of how these processes work by integrating domestic economic conditions and politico-institutional factors into the same framework.

The literature on the political economy of fiscal policy dates back to the nineteenth century with the Italian and Swedish schools of public finance (see Casares Ripol, 2002). In this century, the work of Buchanan (1960) and Buchanan and Wagner (1976) connecting the inability of voters to understand the caveats of fiscal policy with the government's tendency to deviate from the optimal path revived the interest on the political determinants of fiscal policy.

Since the end of the eighties a substantial number of scholars started to study different institutional and political aspects influencing the fiscal decisions made by governments. Initially, all these new politico-economic models of fiscal decision departed from the tax-smoothing framework described in the previous section, and tried to explain observed deviations in the smoothing behaviour as the result of institutional factors mediated by electoral constraints (12). These new models varied substantially in the type of electoral system (13), the degree of fiscal centralization (14), and the budgetary laws (15) under which fiscal policy decisions were taken. But in general, their most important contribution was to develop a new theoretical framework under which the effect of political factors on fiscal economic decisions could be empirically tested (16).

(12) See the classical work by Roubini and Sachs (1989a, 1989b) that related instability of the government associated to its relative fragmentation, and the proclivity of some types of electoral systems to generate coalition governments. For a literature review on the political economy of budget deficits, see Alesina and Perotti (1995); and Persson and Tabellini (1999). See also Franzese (2002).

(13) For the effects of electoral systems on fiscal policy, see Grilli, Masciandaro and Tabellini (1991); Halleberg and Von Hagen (1997); and Milesi-Ferretti, Perotti and Rostagno (1999).

(14) For models on intergenerational distribution see the very first work of Musgrave (1959), and the more recent by Cukierman and Meltzer (1989). And for models on intragenerational geographical distribution see Weingast, Shepsle and Johnson (1981).

(15) For the effects of different budgetary rules related to spending limits see Halleberg and Von Hagen (1997), and Perotti (1998).

(16) For a detailed analysis of the theoretical contributions of these different new political economy models, see De Wolff (1998).

This first wave of theoretical and empirical literature on the political determinants of "deviated" fiscal policies, served as the basis for a second wave of studies, during the second half of the nineties, that aimed at answering what could be the economic and political effects of correcting those "deviated" fiscal policies through strong fiscal adjustments. In terms of economic effects, the most relevant articles were those that presented the non-Keynesian effects of a certain type of fiscal consolidations (17), and those that discussed the importance of the timing (18) and composition (19) of fiscal adjustments for the likelihood of their success. And regarding the possible political effects of undertaking a fiscal adjustment, the most important studies were those that surprisingly demonstrated that large consolidations do not have to be necessarily associated with electoral defeats (20).

Again, as in the previous section, the abundancy of studies in the area calls for a narrowing of the scope to focus only on those factors directly affecting the cabinet when confronted to the politically difficult decision of launching a fiscal consolidation. In this context, there are three major politico-institutional determinants that help explain the observed variation in adjustment strategies. They are: (1) the degree of fragmentation in decision-making; (2) the proximity of elections, and; (3) the ideological background of the cabinet that takes fiscal policy decisions.

3.1. Fragmentation of Decision-Making

Most studies dealing with the problem of public deficit creation and public deficit reduction have primarily focused on the idea that fragmentation in decision-making is negative for expenditure control. The reasoning behind this idea is the following: if a majority has to be formed to pass any legislation on the budget, and there are a lot of parties that need to be satisfied to count on their vote, then a balanced budget will be very difficult to achieve because each group in the majority will push for particular spending programs, but it will only internalise a part of the costs and distortions of the associated increase in revenues needed to equilibrate the budget (Weingast, Shepsle and Johnson, 1981).

Therefore, the larger the number of actors with voice in the fiscal decision-making process, the stronger the pressure for more expenditures, and thus the larger the deviation from the optimal fiscal policy. For example, coalition governments or big cabinets (with many spending ministries) would be less likely to undertake a fiscal adjustment.

(17) See McDermott and Wescott (1996); Giavazzi and Pagano (1990); and Alesina and Perotti (1996).

(18) Von Hagen, Hallett and Strauch (2001) find evidence that "governments are more likely to undertake consolidation efforts when the domestic economy is doing well (...) and [these adjustments] are more likely to be successful if started from high debt-GDP ratios" (pp.12-14). Also, accompanying tax reforms and a labor market reforms will increase the chances of success of the fiscal adjustment. In general, gradual implementation of reforms can enhance their political support, even when these reforms are complementary (see Lindbeck, 1994).

(19) See Alesina and Ardagna (1998).

(20) Alesina, Perotti and Tavares (1998) show that large consolidations, and those mostly based on public wages and transfers, are not conducive to electoral defeat or a change in the government more frequently than average.

Alesina and Drazen (1991) show in a war of attrition model how the distributional struggle among different interest groups delays the adoption of the efficient policy of balancing the budget (21). They also show that the more polarized the groups are in a country, the group that concedes first bears a relatively higher burden, and then each group tries to hold longer and stabilization is delayed. The predictions of this theoretical work have been confirmed by many empirical studies. Both Roubini and Sachs (1989a, 1989b) and Grilli, Masciandaro and Tabellini (1991), found that fragmented governments, defined in a scale called "type of government" ranging from majority governments to minority coalitions, tended to be associated with larger public deficits.

In fact there is a significant correlation between certain institutional frameworks and concrete political outcomes. Consequently, to consider the effect of electoral systems or polarization of the electorate on the type of fiscal adjustment implemented, will be nothing but analysing proxies instead of actual factors. If more proportional systems are more likely to generate coalition governments (as is the case), then it would be more accurate to study the effect that coalition size or cabinet size have on those strategic choices.

Therefore, in the context of fiscal adjustment episodes, one would expect proportional electoral systems producing large coalitions and big cabinets, and those being negatively correlated to the likelihood of starting a fiscal consolidation. If forced to do so (in the context of the Maastricht process, for example), these fragmented governments would probably prefer to do the fastest adjustment possible, and through a revenue-based strategy of adjustment that leaves the level of expenditures unchanged. Note that coalition governments do not necessarily have to be associated with a lot of spending ministers. Sometimes this is the case, but in other situations, as usually occurs in Italy, different parties agree to form a government as long as all parties' elites get a position in the cabinet, even if those are merely representative ministries and do not have spending powers.

This is so, because coalition governments are made of different parties representing different groups of the electorate that they want to satisfy. Satisfaction of those groups does not necessarily mean direct transfers of money (even though sometimes it is the case), but it will certainly imply the implementation of at least part of the policies contained in their electoral programs. The higher the number of different policies to be implemented the higher the expenditures generated, and the higher the level of revenues that must be levied to finance those expenditures. In countries like Belgium, where the electorate is very fragmented (divided by ideological, religious and nationalistic cleavages at the same time), and the proportionality of its electoral system tries to provide representation to all these groups, governments have been traditionally formed by more than three parties. The skyrocketing levels of their public debt reflects, precisely, the historical tendency of these fragmented governments to spend more than what they collect, and to finance the difference issuing debt.

(21) A war of attrition model consists of a group of players locked in a battle, in which all make and accumulate losses as long as the battle lasts. The one who stays longest wins the prize. This model was first formalized by Riley (1980).

3.2. Proximity of Elections

Elections can influence the government's decision on the budget in various ways.

First of all, if the government thinks that it will be re-elected when the economy is growing and the unemployment rate is low, then it will be willing to initiate a fiscal expansion just before the election to increase the probability of being re-elected. This behaviour on the part of government will generate electoral business cycles (22). But if this behaviour is never punished by the electorate, it will also generate progressively accumulating debt associated to each fiscal expansion previous to every election. This type of electoral influence on fiscal policy only holds under two assumptions: (1) there exists fiscal illusion among voters, according to which they overestimate the benefits of current expenditures and underestimate the future tax burden that will be needed to finance current expenditure (23); and/or (2) voters are totally misinformed, and this is why it is difficult for them to fully understand the details of public budget's composition and its long-term impact. Thus politicians that give validity to these previous assumptions will be willing to cut taxes and increase public consumption and transfers before elections.

The second type of electoral effect on fiscal policies is related to the previous one, and has to do with the strategic use of debt by the incumbent government. For example, is a conservative government that dislikes the provision of public goods, is certain that it is going to be substituted by a leftist spending government willing to expand the provision of public services, it may find strategically optimal to leave less money to spend to the incoming new cabinet. By leaving an important amount of debt, the conservative government would have tied the hands of the leftist government, and would have obliged it to raise new taxes (which is unpopular) and/or not to comply with its electoral program of expansion of public services (which will cause strong disappointment in its electorate). With this strategic use of the debt, the incumbent conservative government would have dramatically increased its probabilities of defeating the new leftist government in the next round of elections, and coming back into government (24).

Taking the previous literature into consideration, one would expect proximity of elections to decrease the probability that any type of government starts a fiscal consolidation. Or if it is inside a fiscal adjustment episode, one should expect proximity of elections to increase the probability that the adjustment effort ends, because it is very unpopular and reduces the probability of being re-elected. With respect to the composition of the fiscal adjustment, proximity of elections should be associated with a stronger preference among governments for not reducing the most popular items of the budget (like transfers and family allowances), and cutting instead other items if this is necessary for the fiscal adjustment to succeed.

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(22) See Nordhaus (1989) and Alesina, Cohen and Roubini (1992).

(23) See Buchanan and Wagner (1976) for fiscal illusion.

(24) See Persson and Svenson (1989) for this concrete example. And for a more general overview of the models that analyse the strategic use of debt, see De Wolff (1998) and Franzese (2002).

3.3. Ideology of the Party in Government

Finally, the third political element that is very likely to have an effect in the formulation of fiscal policies and fiscal adjustment strategies is the ideology of the party in government.

Obviously, those scholars that consider a possible role of the government's ideology, depart from Down's assertion that policy-makers are only office-seekers, and from Lindblom's assertion that economic policies tend to converge as the role of businesses in the economy gains importance.

With respect to Down's statement that political parties "formulate policies in order to win elections, rather than win elections in order to formulate policies" (Downs, 1957: 28), those scholar base their rejection to that understanding of politics on two arguments. First, comes the argument spelled out by Przeworski and Sprague (1986), Alesina (1989) and Alesina and Rosenthal (1994) according to which the prospect of new parties entering to fill any ideological gap left unoccupied, the threat of abstention by voters with strong ideological preferences, and the crucial role played by party activists to control the degree of ideologization of their candidate, are three factors (25) that contribute decisively to generate centrifugal pressures in two-party systems. Second, if the left benefits electorally from pursuing interventionist economic policies that alleviate the situation of the workers and the poor, and the right benefits from being more supportive of market forces (26), one could expect that those parties keep pursuing differentiated economic policies, because this behaviour will satisfy at the same time their policy preferences and their goal of re-election.

Together with the previous argument that centripetal competition to win the median voter means the end of partisan politics, most advocates of the "unique economic policy" thesis have argued that increasing globalization offers a new exit possibility to investors threatened by taxing leftist governments. The argument is based on the old argument made by Charles Lindblom (1977) according to which, because government's depend on good macroeconomic performance to be re-elected, and this good performance depends in turn on the investment made by capitalists, the best option for every government is not to tax capitalists and prevent from intervening in the economy. This argument has been lately reinforced by the fact that under the current globalization process, capitalists not willing to pay the taxes imposed by interventionist governments, not only can decide not to invest and consume their profits instead as they could do before, but now they can also decide to "fly away" somewhere else with their capitals, where "cheaper" conditions for investment exist.

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(25) More concretely, the three factors that speak against the policy convergence hypothesis are: "(1) In order to be elected as the party's candidate a politician has to take the party's median position. For credibility and reputation reasons he cannot change his position later; (2) If parties can choose their ideology, new parties may form to suit a group that is currently not represented and political fragmentation will ensue; (3) Unhappy voters can abstain from voting." (De Wolff, 1998: 29).

(26) For this argument, see Lipset (1961); and Klingemann, Hofferbert and Budge (1994).

Again, those scholars that defend the influence of idology in economic policy-making have three reasons to reject the previous assertion that investors are the policy-makers of today.

First, the Welfare State consensus of the postwar years that channelled the fight of the working class through capitalist democracy, in exchange for welfare systems and worker's participation on the distribution of the growing output generated by capitalist production (Przeworski, 1986), still holds today. Capitalists trying to break that consensus will face again fierce opposition by workers, mobilized at the domestic level by old trade unions, or at the international level by new anti-globalization movements.

Second, market integration and globalization increases the vulnerable population by increasing market dislocations and risk exposure, and thus increases citizen's demands for political intervention in the economy to compensate wealth losses and provide new safety nets (Garrett, 1998).

And third, it has been proved that those economies in which encompassing trade unions have made possible growth without inflation, are economies that provide better conditions for investment (27). This is so because more equality in the distribution of income, in countries with comprehensive public health and education systems, generate economies with very productive workers and very stable societies, that grow more (28) and thus are very attractive to investors.

But the assumption that ideology has a role to play in economic policy making in general, and in fiscal policies and fiscal adjustment strategies in particular, is not only based on all those previous theoretical arguments. On the contrary, it is also based on the convincing empirical evidence found by prominent political economists that supported the thesis that politics and ideology matters for economic policy-making and economic policy outcomes.

The first literature on the subject provided empirical evidence that supported the thesis that left-wing governments fought unemployment while right-wing governments were especially worried about inflation (Hibbs 1977, 1987).

This clearly meant that the former used Keynesian policies of demand management to achieve full employment, while the latter maintained small and balanced budgets to let the market achieve its full employment equilibrium, regardless of its equality consequences. Nevertheless, many studies came immediately to demonstrate that after the oil shocks of the seventies, governmental policies on the demand-side only had temporary effects because of rational economic agents (29), were inflationary ex-

(27) The literature on the impact of labour market institutions on the economy is vast. For a brief overview, see the original theoretical work by Olson (1982), and the later empirical studies by Calmfors and Driffill (1988), and Golden (1993). See also Boix (1996, 1997, 2000), and Garrett (1998). Notermans (2000) has lately expanded the analysis of the impact of labour market institutions to study their effect not only on the success of interventionist economic policies, but also in the success of social democratic or liberal policy regimes. He affirms that while social democratic policy regimes need labour market institutions that contain wages to prevent inflation, liberal regimes need labour market institutions that maintain nominal wages, to prevent the price level from falling. These regimes end when their required institutions change.

(28) For example, Alesina and Rodrik (1994) present empirical results that show that "inequality in land and income ownership is negatively associated with subsequent economic growth" (pp. 465).

(29) Alesina (1989); Alesina and Roubini (1992).

cept under certain underlying conditions of the labour market (30) and depended of the State (31) and on the evolution of the international economy (32).

Thus, political parties were only left with the possibility to affect economic policies on the supply side. Here again, partisan differences of economic policies were found. Boix (1996, 1997) has recently demonstrated that left-wing governments are likely to implement interventionist supply-side policies, through the public provision of human and physical capital, to increase growth and the competitiveness of the economy, and make better the worse-off. Capitals will not fly out of the country to avoid higher taxation if public investment is expected to increase overall productivity in the economy.

On the other hand, right-wing cabinets consider public provision of capital inefficient and distortionary. They "expect capital to invest in a way that will maximize its individual rate of return and hence, in the absence of externalities, the social rate of return" (Boix, 1997: 818).

Updated empirical evidence for the fifteen EU Member States shown in Table 1, seems to corroborate again these different approaches to public investment, even during the years of strongest fiscal consolidation in the EU previous to the Maastricht exam. In countries with left-wing governments, the average share of public investment to GDP between 1993-1997 was almost half a point higher than the average public investment in countries with right-wing governments.

TABLE 1

AVERAGE PUBLIC INVESTMENT BY CABINET'S IDEOLOGY IN THE EU, 1970-2000

Average public investment (%GDP) by government (EU-15):	**1970-1989**	**1990-2000**	**1993-97 (Maastricht Adjustment)**
Right-wing governments	3.30 (n=145)	2.68 (n=59)	2.61 (n=28)
Center governments	3.75 (n=60)	2.75 (n=62)	2.73 (n=31)
Left-wing governments	3.78 (n=78)	2.88 (n=43)	3.06 (n=16)

Source: Own elaboration. Data from AMECO.

Therefore, after taking into account all these previous considerations, the "partisanship hypothesis" regarding the composition of the budget and the strategies of fiscal adjustment, has to be based on the two general assumptions under "which scholars have modeled the impact of government partisanship on economic policies. In the first place, all political parties prefer policies that maximize growth (...) [and] in the

(30) Cameron (1984); Álvarez, Garrett and Lange (1991); Scharpf (1987).

(31) Alesina and Summers (1993); Hall (1986).

(32) Alt (1985); Garrett (1998); Frieden and Rogowski (1996). This review of the literature on partisan economic policy management is based on the review made by Boix (1997: 817).

second place, parties adopt distinctive economic strategies depending on their redistributive consequences" (Boix, 1997: 816).

It is plausible to assume that socialist parties have their electoral constituency among workers and the middle and low-income part of the population (at least below the average income of the median voter). These sectors are the most vulnerable to cyclical downturns and suffer from different barriers to equal access to opportunities and services, as a consequence of their purchasing power and their education. Thus, socialist parties, representing these sectors, while giving importance to economic growth, are also especially worried about how the economic growth is distributed and about equality in general.

Ideally, socialist parties will use the public sector to smooth the impact that economic downturns have on the mentioned classes (through unemployment benefits and social transfers) and will try to redistribute income and promote equality (33). Then, following the socialist preference for equality, redistribution, social benefits to the unemployed, and interventionist supply side policies in the form of public provision of human and physical capital, one should expect left-wing governments to be associated with higher public expenditures on public consumption, social transfers, public investment and the wage government bill to pay for an extensive public administration.

To finance all these expenditures, left-wing governments are expected to tax more and more progressively. Higher public expenditures financed by higher public revenues do not mean that one should expect left-wing governments to run deficits more often than right-wing governments. Stronger presence of the State in the economy does not initially have to be associated with unbalanced budgets. Moreover, according to Keynesianism, demand management of the economy, requires that surpluses are built during periods of economic growth, to be used for consumption smoothing during periods of recession. Also, to intervene on the supply side of the economy through public investment socialist governments should prefer surplus or close to balance budgets.

By contrast, right-wing parties mostly obtain their votes from the economically accommodated part of the population (or at least with average income above the median voter's income). These people have more private resources to smooth their personal consumption in periods of economic downturn, they care especially about inflation, and as potential private investors, they suffer most from the crowding-out effect of public intervention in the economy.

Thus, right-wing governments will prefer to run balanced and small budgets, because this means lower presence of the State in the economy. As a result, right-wing governments tax less and spend less than socialist governments. Lower levels of expenditures to GDP will require lower levels of public revenues, and ideally less distortionary taxes of market mechanisms and private incentives.

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(33) According to Glyn (1998: 2), the common aspirations of social democracy in Western Europe "can be divided into three broad categories: full employment, the welfare state and redistribution, and, finally, supply-side interventions aimed at guiding and controlling capital."

With regards to the effect of ideology on fiscal adjustment strategies, one should expect both socialist and conservative governments to start a fiscal consolidation with the same probability. Nevertheless, given their preferences, they should be expected to follow opposite adjustment strategies, not in their timing and duration, but yes in their composition. Left-wing governments should prefer revenue-based strategies, and if forced to freeze or reduce expenditures they should try to maintain the government wage bill, transfers payments and public investment, in order to maintain their capacity to intervene in the economy in the future. While right-wing governments should prefer expenditure-based strategies, that allow them to subsequently reduce the most distortionary taxes and expenditures of the budget (34).

4. Conclusion

Based on an exhaustive analysis of the literature, this article has highlighted the main economic and political factors that could account for the observed cross-sectional and longitudinal variation in fiscal policies and fiscal adjustments in Europe.

One could have expected that most European economies showed similar fiscal outcomes in the last three decades, given their strong interrelation. In general, there has been a common tendency in the past thirty years to spend more than what was collected, and thus to run deficits and accumulate debt. Nevertheless, despite this general picture, there exists abundant empirical evidence that shows wide variation in the level of public revenues, public expenditures, public deficits and public debt. Even more important is the evidence that shows that when EU Member States decided to correct those imbalances, some decided to undertake successive but short fiscal consolidations, while others pursued strong and one-off adjustments. Not only strategies of fiscal consolidation varied in timing, length and strength, but they also varied in their composition. Some countries decided to follow revenue-based fiscal adjustments, while others followed expenditure-based consolidations.

Economic theory is not sufficient to explain this variation in fiscal policies and fiscal adjustment strategies, and this is why political explanations have been brought into scene. This chapter has discussed in depth the theoretical reasons why the economic cycle and the unemployment rate, prices and monetary conditions, the accumulated level of debt, the degree of cabinet fragmentation, the proximity of elections, and the ideology of the party in government should be expected to affect the formulation of fiscal policies and the adoption of different strategies of fiscal adjustment.

While economic factors and the electoral calendar should be expected to be important in explaining the timing and the duration of fiscal adjustments, other political

(34) In fact, the latest work on this topic by Tavares (2004) shows that cabinets signal commitment and gain credibility by pursuing fiscal adjustments in ways not favored by their constituents, i.e., the left cuts expenditures and the right increases taxes. Probit estimates of the impact of adjustment characteristics on the likelihood of success provide evidence in favor of the fact that cuts in spending by the left and tax increases by the right lead to more persistent adjustments than the reverse.

factors such as the fragmentation of decision-making and the government's ideology are likely to be crucial in explaining their composition.

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