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Abstract

Over the past four decades, the accumulation of policy legacies and public debt has led to a decline in fiscal flexibility in Germany and the United States. By applying an index of fiscal democracy to Germany, the paper illustrates the associated shrinkage of democratic control over budget priorities and compares the developments in both countries.

Zusammenfassung

In den vergangenen vier Jahrzehnten hat die Anhäufung politischer Erblasten und öffentlicher Verschuldung sowohl in Deutschland als auch in den USA zu einer Abnahme fiskalischer Flexibilität geführt. Anhand eines Fiscal Democracy Index für Deutschland schildert der Aufsatz die damit einhergehende Verringerung demokratischer Kontrolle budgetärer Prioritäten und vergleicht die Entwicklungen in beiden Ländern.

Contents

The idea is not new that "policy legacies" may accumulate over time, constraining the choices of elected governments and parliaments and diminishing the capacity of states to respond to emerging social problems (Pierson 1998, 2001; Rose 1990; Rose/Davies 1994; Rose/Karran 1987). Not only is it hard to abolish spending programs even after they have outlived their original purpose, but often programs have built-in mechanisms that incrementally increase the cost – following the logic of compound interest – far beyond what was expected at the time of their inception. This holds in particular for so-called pay-as-you-go social security programs that become more costly as they "mature" in time, i.e., as the number of claimants entitled to benefits increases, and average benefits increase with the number of years of enrollment (Pierson 2001).

Since the late 1970s, the problem of accumulating policy legacies has been a prominent theme in the literature on public finance. In addition to the high survival rate of political programs and the quasi-automatic increase in social security and other entitlement spending, the chronic budget deficits of most democratic states and the resulting rise in public debt have significantly limited the degrees of freedom left to governments in the deployment of scarce fiscal means. Democratic states in particular seem to be under strong pressure to manage distributional conflict in their societies and political economies by augmenting available resources through borrowing from the future. As a result, public debt increases, as does the yearly interest on the public debt. Like the mounting costs of inherited programs and maturing entitlements, debt service is thus likely to consume a rising share of tax revenue, and thereby gradually fill the fiscal space for policy innovation and increasingly preempt democratic choice.[1]

Accumulation of policy legacies may be conceived as a process of institutional sclerosis (Olson 1982) or institutional aging (Streeck 2009). The concepts introduce time as a causal factor in the analysis of institutional change, raising the possibility, for example, that the longer a democratic political system has existed, the less flexible it will be with respect to the allocation of its available resources. From this perspective, a wide variety of themes comes into view. Among other things, it may be hypothesized that tax increases, which would temporarily suspend institutional aging, will be the more difficult to achieve in a democracy the further the aging process has already progressed. The reason is that a tax increase that is used in full or in part to service or pay off the public debt does not directly benefit those who must agree to it. Sclerotic foreclosure of policy innovation over time may in this way become self-reinforcing and eventually undermine the viability of democratic politics as such.[2]

1 For a concise formulation of the problem, see Stiglitz's account of the policies of the first Clinton administration which took office in 1993: "That the deficits were not sustainable in the long run was clear … With a growing debt, the federal government had to pay higher and higher interest rates, and with higher interest rates and more debt, more and more money simply went to pay interest on the national debt. These interest payments would eventually crowd out other forms of expenditure …" (Stiglitz 2003: 35–36)

2 On self-undermining institutions, see Greif (2006) and Greif and Latin (2004).

1 Indexing fiscal democracy

From the perspective of a sitting government or legislature, accumulated policy legacies that occupy a large share of the state's tax revenue pose a problem of "fiscal democracy": they leave little to decide in the present because much has already been decided in the past. Since fiscal democracy is essentially about the flexibility of fiscal resources, it is possible to measure it by the proportion of tax revenue that is not needed to cover obligations entered into in the past – that is, the proportion of tax revenue available in principle to be allocated to newly chosen, current purposes. This is roughly the way in which Eugene Steuerle and Timothy Roeper have constructed their Steuerle-Roeper Fiscal Democracy Index, which was presented in early 2010 in an article on the op-ed page of the newspaper USA Today (Steuerle 2010).[3] Among other things, the index has the advantage that it defines fiscal democracy in gradual-numerical terms – one can have more or less of it – and in a way that makes its development traceable over longer periods, as it can easily be built into a time series. In the following, we will briefly describe the construction of the Steuerle-Roeper index for the United States and discuss what it tells us about the trajectory of "fiscal democracy" in the past four decades in the leading Western nation. Following this, we will present a similar index for Germany and use it to compare the German situation to the American one.[4]

The fundamental distinction underlying the Steuerle-Roeper index is between dedicated and disposable, or mandatory and discretionary, government spending.[5] It is relatively straightforward to operationalize for the United States, where only discretionary budget allocations are voted upon by the Congress and are on this basis easy to identify as such. Mandatory expenditure is not voted on because it is considered to be driven by events beyond the volition of legislators, in particular the incidence of social security or unemployment insurance claims, or the costs of medical care under the federal health care programs, Medicare and Medicaid. Mandatory programs create legal entitlements on the part of citizens to benefits that cannot be refused or reduced as long as the entitlements exist. Of course, Congress may cut entitlements, such as pensions, and thereby reduce mandatory spending. To do this, however, it must rewrite spending laws, instead of simply cutting or placing a ceiling on budgetary allocations.[6] Like

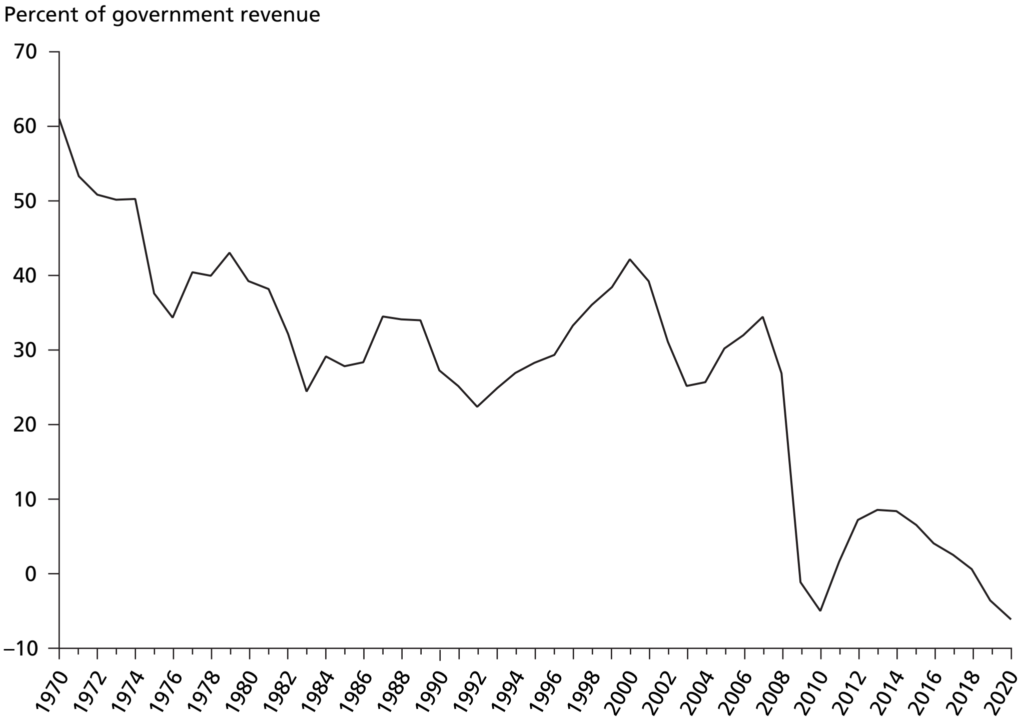
3 See also Steuerle and Rennane (2010).

4 We are grateful to Gene Steuerle and Stephanie Rennane for letting us have the latest version (February 24, 2010) of their fiscal data and allowing us to use it for our calculations.

5 "It is an index of how much 'give' or 'slack' or 'flexibility' there is in the budget or how much 'dead men rule'" (personal communication from Eugene C. Steuerle, February 11, 2010).

6 "Mandatory programs are those that make payments every year regardless of any action by the legislature, whereas other programs must be appropriated each year. The complication politically is that mandatory programs require positive action to be slowed down, whereas discretionary programs require positive action to be increased. In other words, mandatory programs are favored over discretionary ones. At a more complicated level, many mandatory programs grow automatically, then in political language a slowdown in their growth rate is called a 'cut,' whereas an increase in discretionary programs, even just to compensate for inflation, is called an 'increase'" (personal communication from Eugene C. Steuerle, February 11, 2010).

Figure 1 Steuerle-Roeper Fiscal Democracy Index, United States, 1970–2020



Source: Rennane/Roeper/Steuerle (2010); based on historical data from the Office of Management and Budget and 2010 Congressional Budget Office projections. Excludes TARP spending.

entitlement programs, debt service is considered mandatory spending since the interest due to creditors represents a legal entitlement that cannot unilaterally be reduced by the Congress. Defense spending, however, is considered discretionary as it is voted on every year. Discretionary spending – what is left of government revenue after mandatory spending and debt service – is expressed in terms of government revenue, rather than government spending, in order not to distort the measure of fiscal democracy by including new debt in its base.[7]

Since the beginning of the 1970s, the trend in fiscal democracy in the United States has been downward, from 60 percent in 1970 to a little less than zero percent in 2009 (Figure 1).[8] There were four cyclical upswings between 1970 and 2009; the strongest oc-

7 The formula for the index, then, is "1 – [(mandatory spending + interest)/revenues], multiplied by 100 for conversion to a percentage." The index "falls when revenues are reduced without cutting mandatory spending, and it is reduced when mandatory spending is increased without increasing revenues" and is therefore "neutral on the size of government" (personal communication from Eugene C. Steuerle, February 11, 2010).

8 Meaning that, in the year after the beginning of the current "financial crisis," mandatory expenses including interest payments exceeded total government income. This was caused by a simultaneous decline in revenue and a rapid increase in mandatory spending. As a result, all discretionary spending, including military expenditure, had to be debt-financed.

curred in the period between 1992 and 2000 – the "Clinton prosperity" – when revenue doubled while interest payments stagnated as a result of falling interest rates. Subsequent economic downturns, however, always ended with a new record low, except once (2000–2003). The current crisis has critically exacerbated the problem, but essentially it has done nothing but accelerate a process that has long been under way. Projections for the coming decade by the Congressional Budget Office (included in Figure 1) foresee a slight increase in fiscal discretion until 2013; thereafter, the index is seen to fall and turn negative again.

There is little ambiguity in this condition. "As the amount we can spend on the new and unforeseen shrinks," writes Steuerle (2010),

> so does each generation's democratic control of social and economic priorities … For the first time in U.S. history, in 2009 every single dollar of revenue was committed before Congress voted on any spending program. Meanwhile, most of government's basic functions – from justice to education to turning on the lights in the Capitol – are paid for out of swelling, unsustainable debts.

2 A Fiscal Democracy Index for Germany

Applying the Steuerle-Roeper index to Germany requires a few operational adjustments where legal definitions, parliamentary procedures, and political circumstances differ. It seems, however, entirely feasible. First, a problem arises in applying the concept of "mandatory spending" to the German situation. Unlike the United States, the German legislature votes every year on the entire budget, and in this respect, there is no formal distinction between discretionary and mandatory spending. However, there are at least four categories in the German federal budget, in addition to interest payments, that are de facto mandatory, in the sense that the government is legally obliged to pay for them. While the parliament inserts the required amounts in the budget, as estimated by the Ministry of Finance, and in this way appropriates them, like in the United States, the only alternative for it doing so would be to change the respective entitlement legislation. For the period beginning in 1970, the four categories are:

(1) The so-called *Kriegsfolgelasten* stemming from World War II. This refers to obligations resulting from the war, including reparations and payments to victims of the Nazi regime. In 1970 this category still amounted to roughly ten percent of the federal budget. In subsequent decades it continuously declined and has now almost disappeared.

(2) Personnel. Under German labor law it is not possible for the government unilaterally to cut or withhold pay to its employees, even if the legislature were to refuse allocating sufficient funds. Spending on personnel is essentially determined by applicable collective agreements that bind the state as employer.

(3) Subsidies to the (parafiscal) social security funds. Under German law, the federal government is obliged to cover whatever deficits may arise in the social security system (which is funded by a payroll tax outside the federal budget). By now about one third of federal spending is devoted to subsidizing social security.

(4) Long-term unemployment benefits *(Sozialhilfe, Grundsicherung)*. These are legal entitlements of individuals meant to guarantee them a minimum level of subsistence. The benefits are defined by the legislature, but its decisions are in part subject to review by the Constitutional Court.

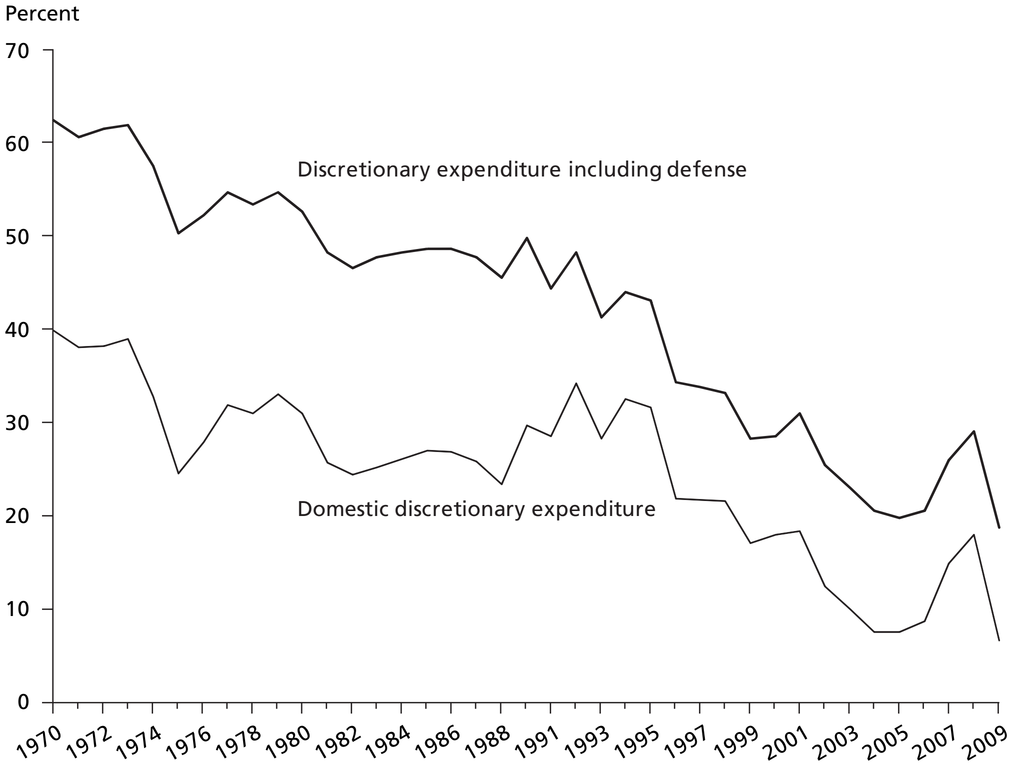
As all four of the above spending categories are "given" unless the legal entitlements of their beneficiaries are specifically changed, we treat them as mandatory in the American sense. Together with the government's expenditure on debt service, they constitute the dedicated part of government spending, as distinguished from the discretionary part.

Another problem relates to defense. Formally, defense expenditures are discretionary, and there is nobody "entitled" to being paid out of the defense budget (except, of course, the military personnel as protected by German labor law). In substance, however, the German military is in its entirety under the command of NATO, and the German defense budget is set to complement NATO and, even more so, U.S. spending. Unlike the United States, Germany has no enemies, no client governments to protect, no specific military objectives, and no strategic doctrine of its own. We have, for this reason, calculated the German index twice, counting defense expenditures in one case as discretionary, in line with American practice, and in the other as effectively beyond the control of the German legislature, and in this sense as mandatory. In the latter case, the resulting index measures the share of government revenues available for discretionary spending on domestic purposes only.

Even more than in the United States, fiscal democracy in Germany, as measured by the index, has been declining since the 1970s (Figure 2). Specifically, more or less steadily growing spending to support the social security system and on social assistance for the long-term unemployed, and also but less so on interest[9], has over almost for decades steadily narrowed the political choices of German governments. Spending on defense has declined, however, particularly in the years immediately after the end of the Cold War. In Figure 2, this is reflected over time in the shrinking distance between the two lines – the upper, broken one treating defense as discretionary and the lower, solid one treating it as mandatory. The diagram also shows that, in the early 1990s when the largest part of the post-1989 "peace dividend" accrued, fiscal discretion with respect to domestic spending recovered for a few years, albeit to continue its decline after 1995. The subsequent increase ten years later was owed to the consolidation effort of the "Grand Coalition" government (Merkel I), while the steep decline that followed after 2008 –

9 As can be seen in all other countries of the developed world, historically low interest rates since the 1990s have significantly lowered the cost of debt service in the last one-and-a-half decades.

Figure 2 Fiscal Democracy Index, Germany, 1970–2009: Federal government revenue



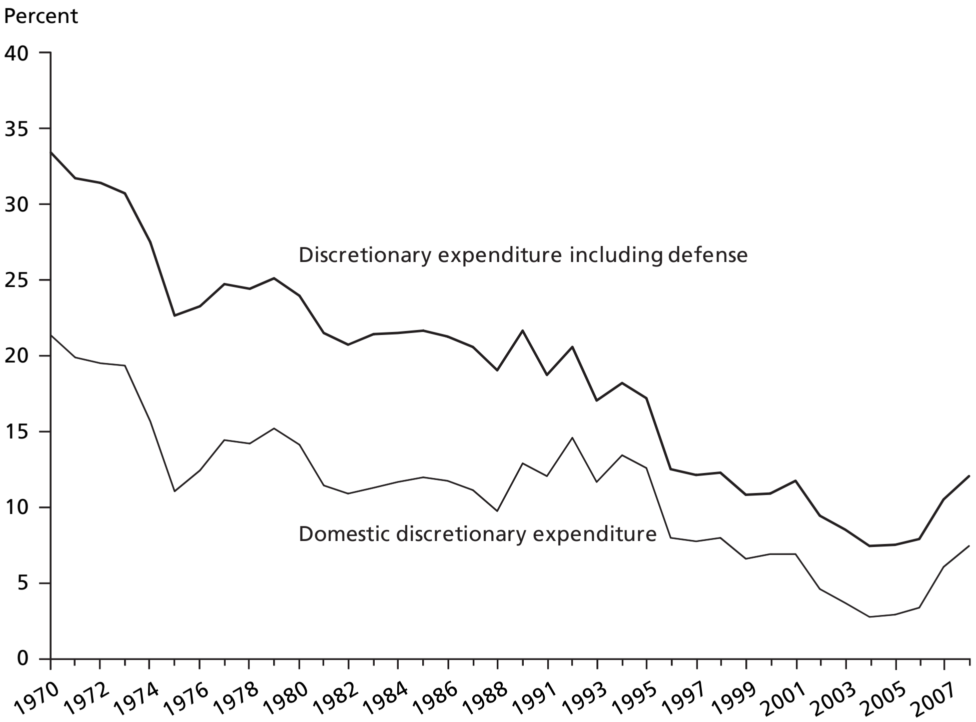
Source: Bundesfinanzberichte 1975–2010; own calculations.

which will continue for at least another two years – represents the fiscal effects of the current crisis of the global financial system.[10]

When comparing Germany to the United States, there is yet another conceptual problem, which results from the different ways the two countries finance their social security systems. In the United States, social security contributions are collected as payroll taxes by the federal government, whereas in Germany they do not appear in the federal budget at all. Although they are taxes for all practical and economic purposes, German social security contributions are paid to and administered by four types of parafiscal funds: one each for old age pensions, health care, unemployment insurance, and care for the elderly. Together, the four branches of the social security system collect contributions amounting to about 40 percent of the real wage, up to an indexed cutoff point beyond which individuals are exempt from paying.

10 Under the balanced budget constitutional amendment of 2009, the German federal government is under a legal obligation to eliminate budget deficits by 2016. It has also committed itself to lower taxes. Things being the way they are, this must mean a further reduction in discretionary spending because federal subsidies to social security, social assistance, and interest payments are bound to increase further, and spending on personnel and defense are fixed for all practical purposes.

Figure 3 Fiscal Democracy Index, Germany, 1970–2008: Federal government revenue and social security contributions

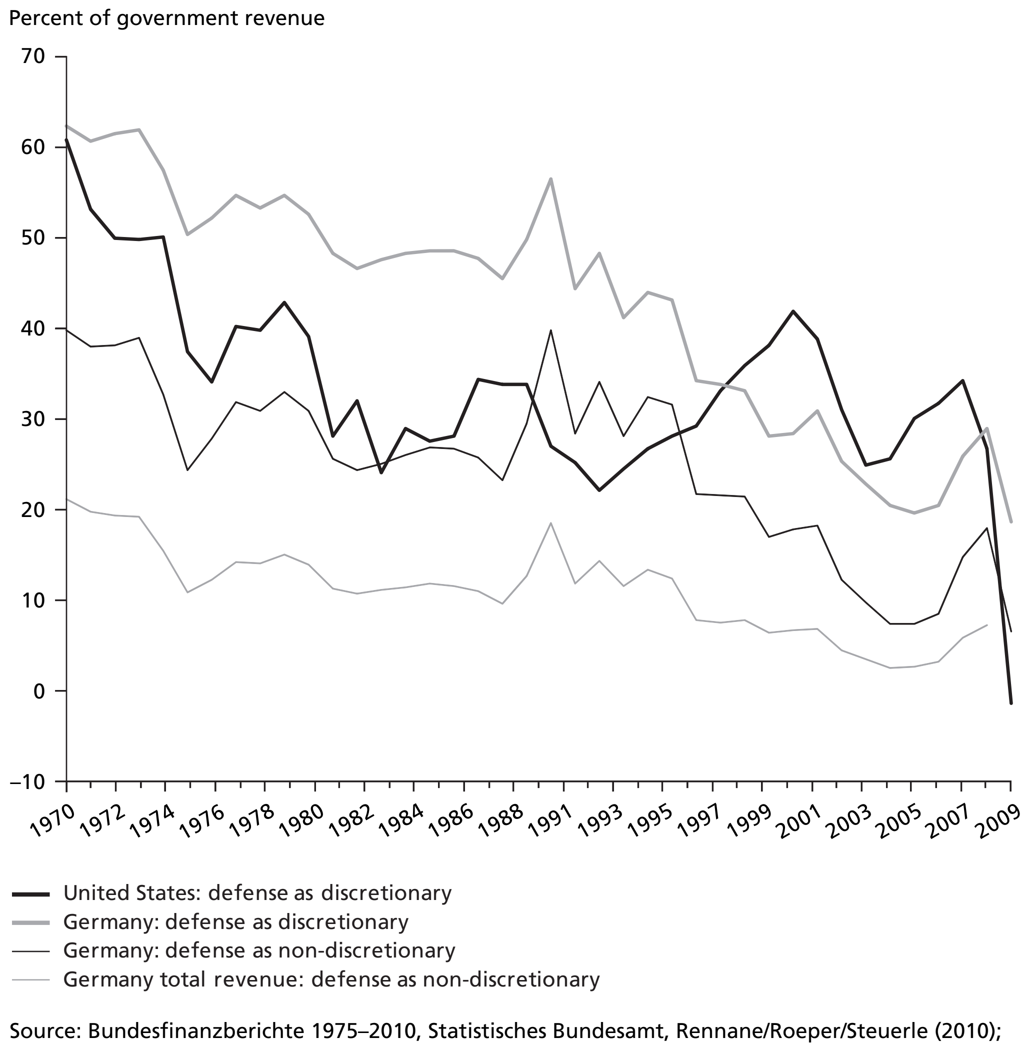


Source: Bundesfinanzberichte 1975–2010, Statistisches Bundesamt; own calculations.

To increase comparability with the United States, we have, in a further version of the Fiscal Democracy Index, added social security contributions to federal government revenues, as though not only the latter but also the former were collected by the state and included in the state budget. The sum of the two, representing the sum total of public revenues at the national level, is used as the denominator of the revised index. In the numerator, we have added the total expenditure of the four branches of the social security system to the federal government's mandatory expenditure, given that the entire expenditure of the social security system is, by definition, mandatory. Because an exact accounting of total expenditure for all four branches of the social security system is hard to come by, we have used as a proxy the sum total of social security contributions, which under the pay-as-you-go logic of the German welfare state are almost completely spent in the same year that they are collected.

Since the terms added to the numerator and to the denominator are the same, the effect is that the absolute value of the index declines (Figure 3). This is as it should be, given the fact that social security contributions are entirely dedicated to a pre-established purpose and are not available for discretionary re-allocation. The extent of the decline reflects the magnitude of the social security contributions collected by the parafiscal institutions of the welfare state in relation to government revenues proper. Over time the revised index follows basically the same path as the index based on the revenues of the federal government alone, apart from the fact that, due to a relative increase of social security contributions compared to federal taxes during the period in question, the decline in overall fiscal discretion is (even) steeper. Since the figures on social security contributions collected in 2009 were not yet in at the time of writing, the effect of the financial crisis is not yet visible in Figure 3. However, there can be no doubt that the crisis has further and dramatically reduced fiscal discretion.

Figure 4 Fiscal democracy, United States and Germany, 1970–2009



Source: Bundesfinanzberichte 1975–2010, Statistisches Bundesamt, Rennane/Roeper/Steuerle (2010); own calculations.

3 The United States and Germany compared

In both countries, Germany and the United States, fiscal democracy has steeply declined since the early 1970s (Figure 4). Moreover, the global financial crisis that began in 2008 has undone any gains in fiscal democracy made in the late 1990s (United States) and the mid-2000s (United States and Germany). In effect, the crisis seems about to eliminate almost completely any space for fiscal discretion in the foreseeable future unless governments are willing, and able economically and legally, to take up new, additional debt.

Until the mid-1980s, fiscal discretion in the United States declined more sharply than in Germany, caused mainly by rapidly rising interest payments. In the 1990s, by contrast, it recovered faster because of economic growth and the budget-balancing policies of the Clinton administration. That the index is more volatile in the United States than in Germany is explained not just by the generally more cyclical nature of the U.S. economy, but also by the greater importance in the United States of defense spending as compared to social security spending.

4 Welfare state, warfare state

The importance of military spending in the United States is also revealed by comparing two versions of the Fiscal Democracy Index, one that considers defense as discretionary and another that, as is more realistic in the German case, treats it as non-discretionary (Figure 5). In the United States, the difference between the two versions is far greater than in Germany, and fiscal democracy is vastly diminished if defense spending is seen not as freely chosen but, as in Germany, imposed by the outside world.[11]

Testifying to the different priorities of the American state as compared to a European welfare state, the index of fiscal democracy turns negative already under Reagan in the early 1980s if defense is classified as non-discretionary. After a brief recovery it approached zero again in the wake of September 11, 2001, and fell to a staggering –40 percent in 2010 – which means that in that year entitlements, interest payments and the costs of the two wars in Iraq and Afghanistan together exceeded federal revenues by roughly one half.

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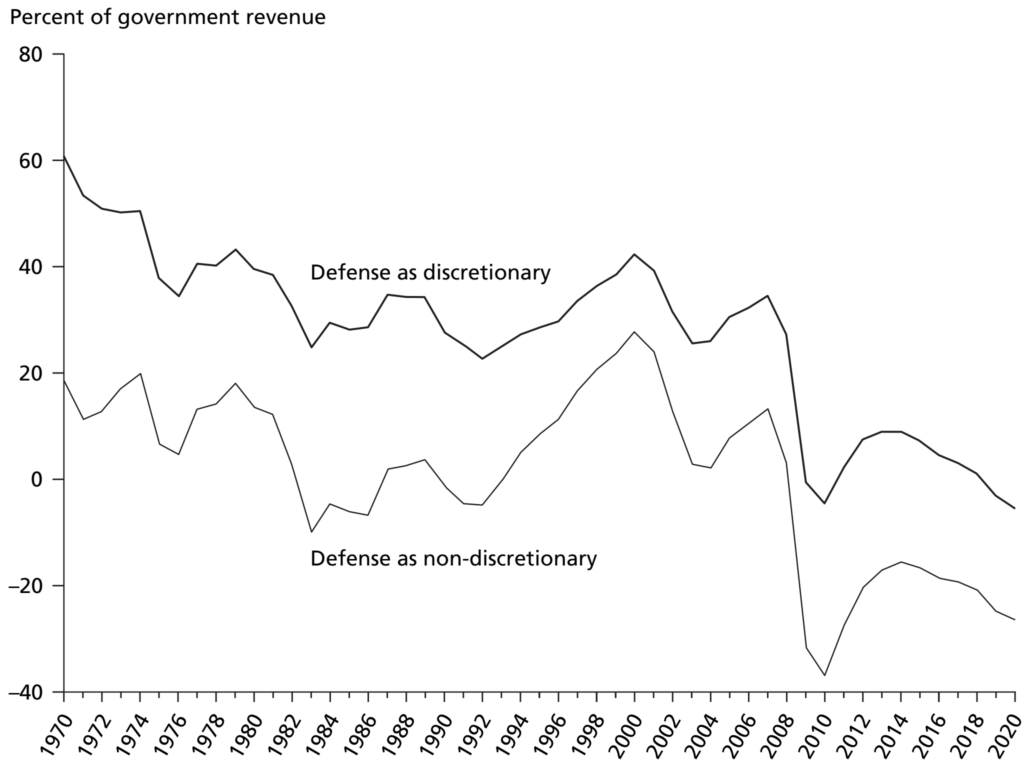
11 Note that, in American public discourse, defense spending is considered as essentially involuntary, as it is perceived to be imposed on the country by its enemies. All parties agree that America must spend on national security whatever it believes it takes, without regard to fiscal or economic constraints, since national security is regarded as the uppermost political objective. There is no difference in this respect between the administrations of Bush and Obama.

Figure 5 Fiscal democracy, United States, 1970–2020, including and excluding defense



Source: Rennane/Roeper/Steuerle (2010); own calculations.

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